



CENTRAL BANK OF THE REPUBLIC OF TURKEY

MONETARY POLICY REPORT 2005-I

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1. Introduction*

The ongoing disinflation process continued in the first quarter of 2005. The persistence of price rigidity in the services sector and the increase in crude oil prices in the international markets, as well as public price adjustments, were the determining factors in the increase in the specified price groups. However, since the secondary effects of these developments were limited, the disinflation process maintained its pace. Special price aggregates, which are announced starting from the beginning of the year within the framework of consumer prices with base year 2003, point to the fact that the disinflation process is based on structural fundamentals rather than temporary factors. In this context, the end-year inflation expectations declined to 7.1 percent, realizing below the target.

Although domestic demand recorded a great recovery in the first half of 2004, it slowed down significantly in the second half. As a matter of fact, seasonally adjusted private consumption expenditure and final domestic demand decreased in the last quarter of the year. Production growth that was stimulated by the demand for intermediary and investment goods, and the increase in stocks observed in the first two months of 2005 indicate that the sluggishness in consumption demand continues. Unlike previous periods, the composition of consumption demand shifted from durable items to semi-durable and non-durable items in the last quarter of 2004. Sales figures in the domestic market pertaining to the first two months of 2005 support the view that this change process continues. However, the increase in demand for the specified consumption goods continues in a controlled manner. Besides, national income accounts pertaining to the last quarter of 2004 reveal that the increase in investment expenditures goes on, albeit at a slower pace. Indicators of the first quarter of 2005 also support this trend. In this framework, ongoing machinery-equipment investments support the productivity increases on the one hand; while, on the other hand, ongoing increases in the construction expenditures boost the total supply potential. These developments provide room for high rates of growth without causing any inflationary pressure.

* This report is prepared by using the data covering the period till 21 April 2005.

During the same period, cost factors did not pose any risks to inflation, either. The appreciation of the Turkish lira in the first quarter of 2005 restrained the pressures arising from input costs via reducing the domestic prices of costly imported raw materials and investment goods. However, the ongoing upward trend in goods prices in the international markets may turn into a risk factor for costs in the coming period. Meanwhile, the rate of increase of real wages accelerated in the last quarter of 2004, albeit still remaining at low levels. In addition, the deceleration of productivity increases in the last quarter of 2004 compared to the last three years indicates that unit labor costs will start to draw support from inflation in the upcoming period.

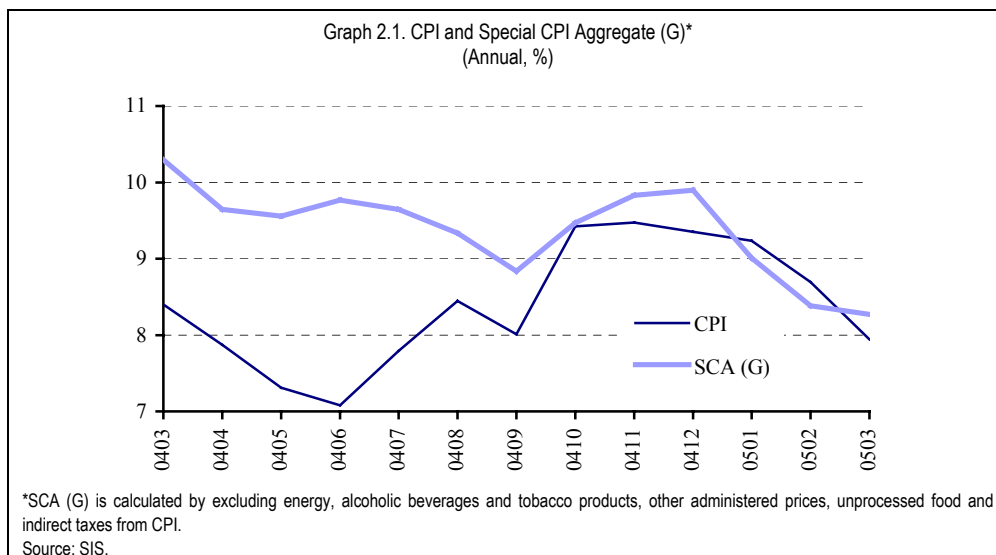
Forecasts about future inflation continued to be consistent with the targets; the economy recorded a structural recovery, the agreement to be signed with the International Monetary Fund (IMF) reached the finalization phase, progress was made in the negotiation process with the European Union (EU) and confidence in the current economic policies increased. In the framework of all these developments, the Central Bank maintained its cautious and optimistic attitude and gradually cut interest rates in the first four months of 2005. In the same period, the Bank also directly intervened in the foreign exchange market in order to prevent excessive volatility as a response to changes in international liquidity conditions and risk perception.

In the framework of a confident environment, the fall in risk premium and the appreciation of the Turkish lira led to a decrease in debt stock. However, as debt stock is still at a high level, the determination shown in fiscal discipline and structural reform should be maintained. This is critical for both ensuring long lasting achievements in terms of the economic program and the success of the explicit inflation targeting to be adopted next year.

2. Inflation Developments

Inflation figures pertaining to the first quarter of 2005 were at historically low levels. While the cumulative inflation according to the Consumer Price Index (CPI) with base year 2003 was 2.15 percent in the first quarter of the last year, it decreased to 0.83 percent in the same period of 2005. As of end-March 2005, annual inflation was realized below the end-year target. Special CPI Aggregates (SCA) are calculated in the framework of the CPI with base year 2003 (Box 2.1). The course of the SCA (G) reveals that the downward trend in inflation does not result from temporary factors (Graph 2.1).

Price figures of the first quarter point to a record-low level of inflation. The course of the special CPI aggregate (G) indicates the lasting nature of the fall in inflation.



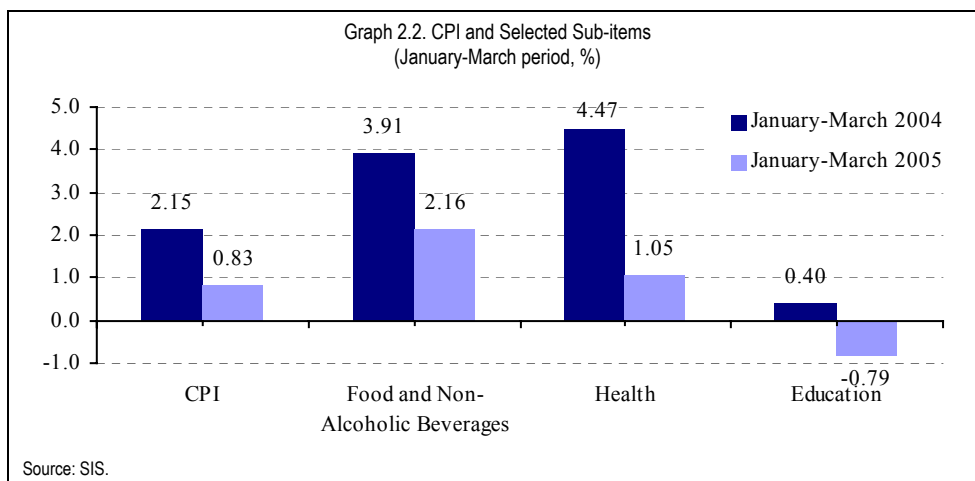
Outstanding factors with respect to inflation in the January–March period can be summarized as follows: (i) the appreciation of the Turkish lira vis-a-vis foreign currencies, particularly in the December–February period, (ii) Value Added Tax (VAT) rebate on the food, health and education sectors at the start of the year, (iii) price rigidity in the services sector, (iv) public price adjustments.

The appreciation of the Turkish lira vis-a-vis foreign currencies, particularly in the December–February period, became the factor restraining the increases in prices of durable goods that are susceptible to exchange rate changes. Meanwhile, the ease of quota restrictions on ready-to-wear clothes and textile products imported from China and the increased competitiveness in the specified sector are believed to affect the prices of the clothing and foot-wear group, which recorded a decrease of 14.55 percent in the January–March period beyond its usual

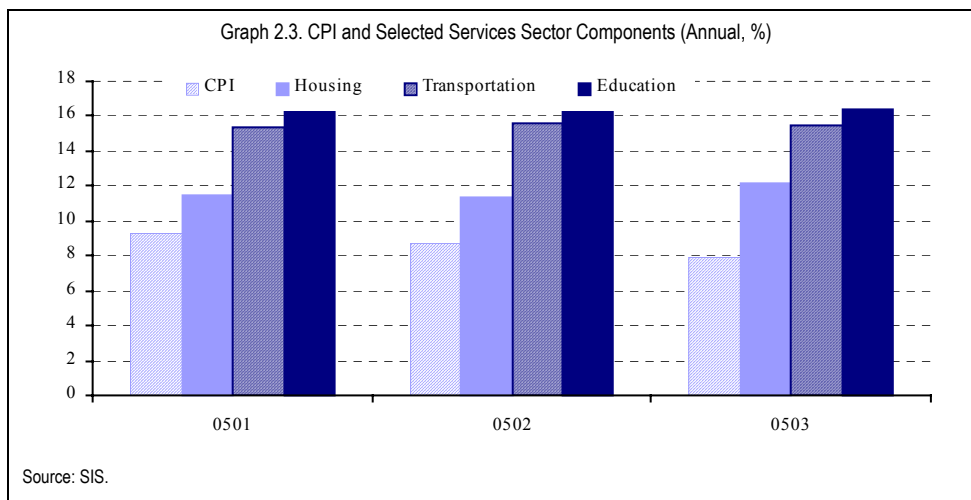
seasonal trend. It is anticipated that the said development might exert downward pressure on the prices of the clothing group also in the upcoming period.

Although the price decreases resulting from the VAT rebate are significant, their one-off nature should always be taken into account.

Meanwhile, the 10 percent-VAT rebate on the food, health and education sectors at the start of 2005 restrained price increases in these sectors to a great extent. This influence is most evident in the prices of health services, which were adjusted for the next six months at the start of the year. However, it should be noted that the above-mentioned VAT rebate has a one-off influence and will lose its impact in the coming periods (Graph 2.2).

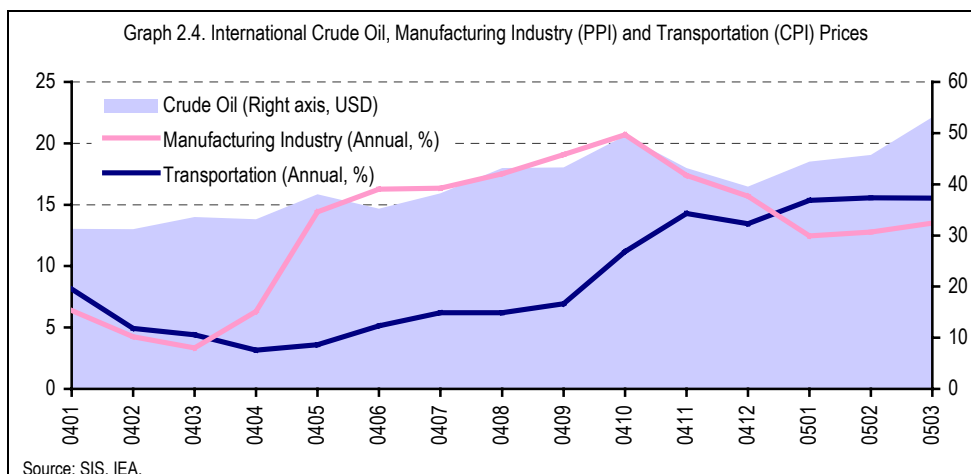


Despite the favorable inflation developments in recent years, the downward trend was less apparent in the service-intensive sectors, and the price rigidity in the services sector continued in the first quarter of 2005 (see Monetary Policy Report 2004 – III, Box II.1 p.8–9 for details of the price rigidity in the services sector). Although prices of rent, restaurant and hotel services decreased compared to the previous year, they are still above the general level of inflation. In this context, economic agents in the services sector should take into account the lasting downward trend in the CPI while devising their pricing schemes so that the rigidity in these sectors can be broken (Graph 2.3).



Another determining factor in inflation in the first quarter of the year was public price adjustments. The increase made in the rates of Private Consumption Tax (PCT) on tobacco and alcoholic beverages in February, was also the main determinant of the prices of alcoholic beverages. As of the February–March period, the cumulative price increase in the specified groups was registered as 19.14 percent. However, this PCT increase was not reflected in prices other than those of certain foreign tobacco brands. Hence, although the quarterly increase in the alcoholic beverages and tobacco group was realized above the general level of inflation, it is considerably below the increase of the previous year.

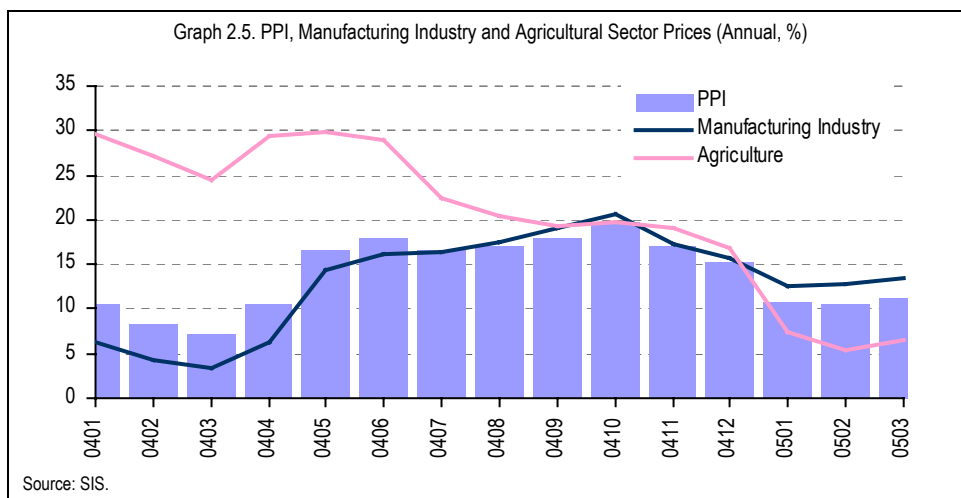
The impact of the public sector on the general price level is managed through VAT rebates and PCT adjustments.



Fuel oil prices, which increased in March due to developments in international crude oil prices and exchange rate movements, stimulated price increases in the housing and transportation groups under the CPI. Moreover, oil prices and exchange rate effects boosted growth in the

Developments in international oil and raw material prices determined price increases in the manufacturing industry.

manufacturing industry prices under the Producer Prices Index (PPI), which is composed of tax-excluded prices (Graph 2.4). Price fluctuations in the agricultural sector decreased in the first quarter of 2005 compared to previous years, due to the measurement and scope changes created by the new indices. In the first quarter of 2005, PPI inflation was confined by developments in the agricultural sector (Graph 2.5).



BOX 2.1. ANALYSIS OF THE NEW PRICE INDICES (2003=100)

In February 2005, the SIS started to issue CPI and PPI with base year 2003 instead of the CPI and WPI with base year 1994. The aim of using these indices is to reflect better changing consumer preferences and to measure inflation more accurately by employing new methods and implementations. The new indices bring about significant changes in the scope of goods, weight of goods, pricing and calculation methods. The number of main expenditure groups, which was 10 in the CPI with base year 1994, became 12 in the CPI with base year 2003 as foods, alcoholic beverages and tobacco expenditure were divided into two groups and a separate group was devoted to communication services. Other important changes in the CPI are the inclusion of technological devices such as cellular phones, laptops and DVDs, exclusion of the imputed rent item, which constitutes a significant part of the housing group, and the increase in the share of energy items including electricity, natural gas and petroleum products. Meanwhile, along with the PPI, the public/private discrimination in the WPI is removed, and, more importantly, sales prices have started to be calculated excluding VAT and similar taxes.

Besides, along with the indices with base year 2003, core inflation indicators called, "special CPI aggregates", have started to be issued in order to nullify the temporary effects observed in consumer prices and to measure the inflation trend in the medium and long term. Seven special CPI aggregates have been created in order to be able to detect any shocks to inflation and to measure their seasonal effects on the inflation trend. The special CPI aggregates are: CPI excluding seasonal products (A), CPI excluding unprocessed food products (B), CPI excluding energy (C), CPI excluding unprocessed food products and energy (D), CPI excluding energy, alcoholic beverages and tobacco products (E), CPI excluding energy, alcoholic beverages, tobacco products, other products with managed prices and indirect taxes (F) and CPI excluding energy, alcoholic beverages, tobacco products, other products with managed prices, indirect taxes and unprocessed food products (G)".

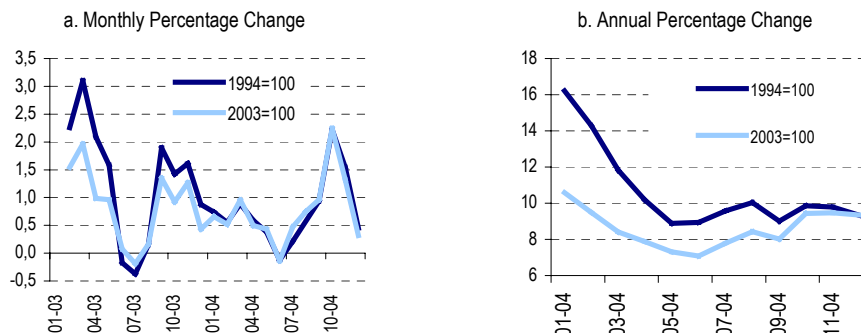
Special CPI aggregates are also considered to be important tools that can be used to explain the reasons behind price changes to the public. Different special CPI aggregates may come to the forefront now and then depending on the quality of the temporary shocks to inflation. For instance, the effect of a change in unprocessed food products, which may emerge due to seasonal factors in consumer prices, can be announced to the public by using a price index excluding the prices of unprocessed food products.

Analysis of the Indices with Base Year 2003 as to the General Inflation Trend and the Pass-through from Exchange Rates to Prices:

The price indices with base year 2003 brought up the issue of whether the inflation rates for the years 2003 and 2004 obtained from the new indices, which include considerable differences, involve any data that are quite different from the indices with base year 1994 with respect to the general inflation trend and pass-through effect. Graph 1 shows monthly and annual rates of increase in CPI's with the base years 1994 and 2003. As shown in the first column of Graph 1, there is a significant difference between the monthly increases of the two indices in 2003. However, this gap had almost been closed as of the beginning of 2004. The difference between the annual inflation trends of the two indices at the beginning of 2004 resulted from the difference between the monthly rates of increase in 2003. In other words, while annual inflation for 2004 appears to have decreased rapidly according to the CPI with base year 1994, it seems to have increased relatively according to the CPI base year 2003 and this difference stems from the differences in 2003. Therefore, before drawing a conclusion about the general inflation trend based on the differentiations in 2003, it should be noted that the new index was first compiled in 2003 and the year 2003 was a trial period for this index.

Another question that arises with the new indices is the size of the pass-through from exchange rates to prices. The answer to the question to which extent the developments in exchange rates affect the general price level, which is measured by using the indices with base year 2003, has two aspects. The first aspect represents the scope of the indices. Compared to the CPI with base year 1994, the CPI with base year 2003 contains more commodity groups that are susceptible to exchange rate movements, therefore the pass-through from exchange rates to prices is reflected more clearly in the CPI with base year 2003. On the PPI side, as prices in the CPI with base year 2003 are tax-exempt; this index is more sensitive to exchange rates. However, this high sensitivity neither results from the method of price compilation, nor points to a marked change in economic terms. In order to make a sensible comparison between the CPI and the PPI, wholesale prices with base year 1994 should be excluded from tax.

Box 2.1. Graph 1. Comparison Between the Rates of Increase of the Indices with Base years 1994 and 2003



Source: SIS.

NOTE: Although the index with the base year of 1994 is still being published after February 2005, the goods and services basket of this index is adjusted to that of the index with the base year of 2003. Therefore, for comparison purposes, the period January 2003 – December 2004 is utilized, where both indices contain different goods and services baskets.

The second aspect represents time. It is very difficult to make comparisons between the course of the transitivity between former and new price indices. This is mainly due to the fact that the new index series have not been observed enough to ensure the credibility of statistical analysis. Hence, the results obtained through these techniques are far from being credible although the known statistical techniques appear to be applicable from a numerical point of view. In this context, it is difficult to analyze the pass-through effect without the aforementioned aspect involving the scope of the index. Considering the fact that every numeral technique has its own limitations, the best approach would be to use the general conceptual framework and predictions of economic theory with caution from a scientific point of view until an adequate number of observations have been made.

Conclusion

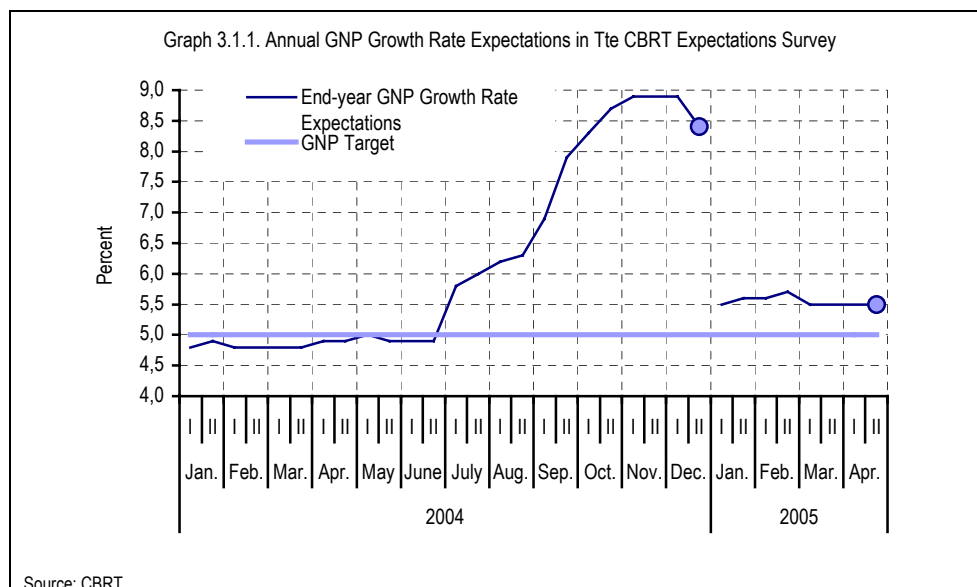
In conclusion, updating the price indices via new methods and applications to reflect consumption and production patterns in the market is considered to be a favourable development for inflation targeting. In light of the current data and predictions, price indices with base year 2003 do not incorporate new economic data on the general inflation trend or on the pass-through effect that is not contained in the price indices with base year 1994. The differences displayed by the two indices as to inflation mainly stem from the differences between their content and methods. Their effects on the responses of inflation rates to seasonality, developments in exchange rates and demand will be analysed more clearly when the number of observations increase.

3. Supply and Demand Developments

3.1. Supply and Demand Balance

In the last quarter of 2004, the Turkish economy continued to grow compared to the first half of the year, albeit at a slower rate. During this period, the Gross National Product (GNP) increased by 6.6 percent compared to the same period of the last year. Despite the relative slowdown in private expenditure in the last quarter of 2004, the continuance of rapid increases in exports and the reversal of contraction trend in public expenditure supported economic growth. In this period, the rise of the value added of the agriculture and trade sector had a positive impact on economic growth, while the rate of increase in industrial production declined compared to the first nine months in line with domestic demand developments. The high growth rate experienced throughout 2004 along with the concurrent decline in inflation and the achievement of end-year macroeconomic targets improved the expectations for 2005. According to the Central Bank of the Republic of Turkey's (CBRT) Business Survey, the end-year growth expectation for 2005 was realized above the program forecast of 5 percent, which was set at the beginning of the year. In the second survey period of April, the expectation was 5.5 percent (Graph 3.1.1).

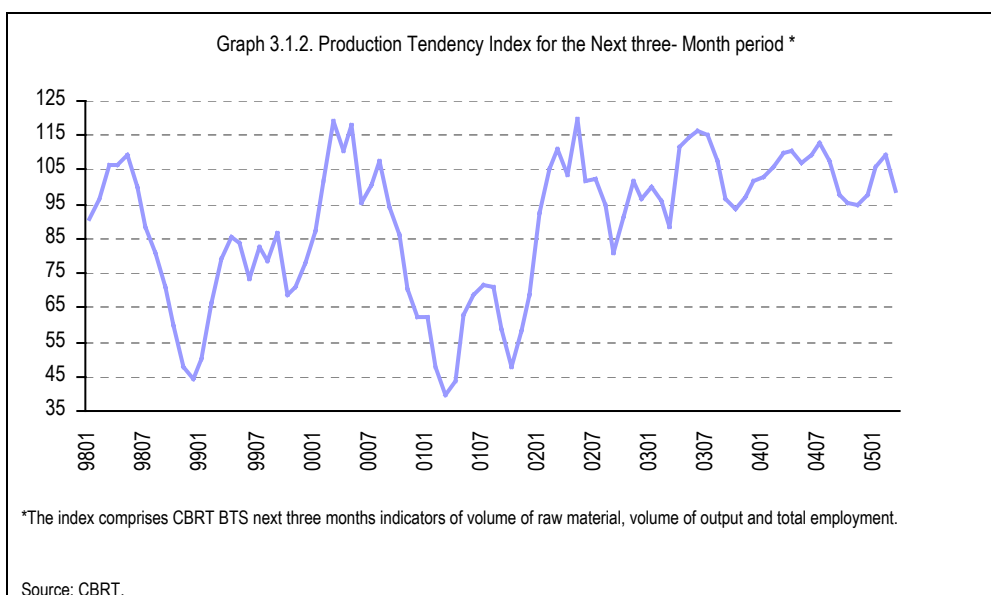
High growth rate experienced throughout 2004 along with the concurrent decline in inflation and the achievement of end-year macroeconomic targets improved the expectations for 2005.



Industrial production developments in the January–February period of 2005 and the expectations for March reveal that the high-rated increase in production also continues in the first quarter of the year. According to

the Monthly Industrial Production Index issued by the State Institute of Statistics (SIS), total industrial production rose by 9.7 percent in the January–February period compared to the same period of the last year. Analyzing the manufacturing industry by sub-sectors, it is observed that the slowdown in consumption demand continues, whereas the existing demand for intermediate and capital goods triggers the growth in production. Accordingly, intermediate and capital goods imports increased substantially in this period compared to the same period of the last year. The increase in non-metallic mineral substances production that points to a revival in the construction sector and the exports-originated rises in vehicles production made an outstanding contribution to manufacturing industry production during the January–February period. According to the SIS data, the capacity utilization in the manufacturing industry was realized as 77.6 percent in January–March period of 2005, maintaining its level of the same period of the last year. Despite rapid increases in industrial production, the same tendency was not observed in capacity utilization rates because of the expansion in production capacity as well as investment expenditure in 2004. In the light of these data, when production and price developments are assessed together, the significance of ongoing investment expenditure and the increase in production without imposing any pressure on prices is better understood.

Despite rapid increases in industrial production, the same tendency was not observed in capacity utilization rates because of the expansion in production capacity due to the investment expenditure realized in 2004.



In January and February 2005, the persisting slowdown in domestic demand, despite rapid increases in industrial production, led to a rise in

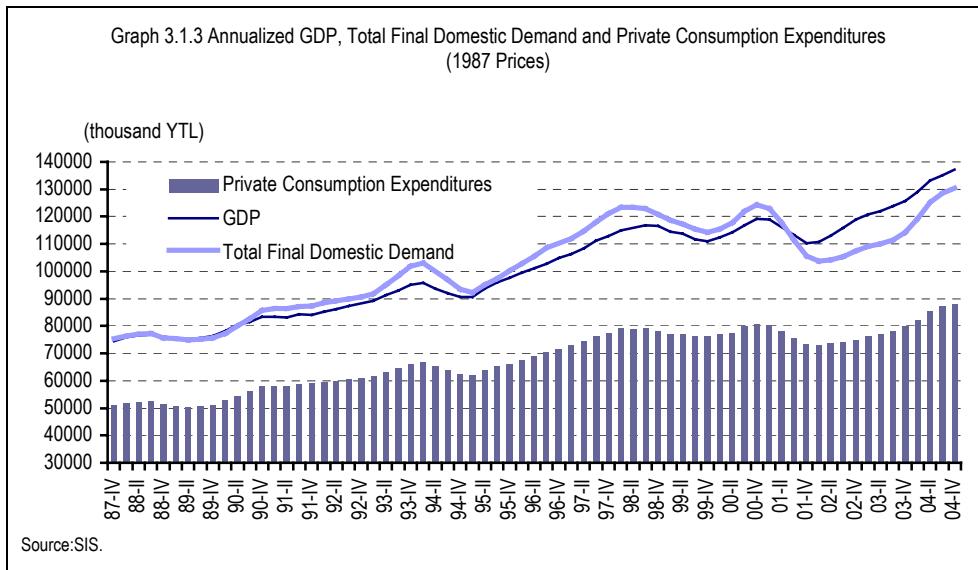
final good inventories. This development is expected to restrict production increases in the coming period. Accordingly, the production tendency index for the next quarter, which has been increasing since December 2004, declined in March (Graph 3.1.2). Considering the current production tendency, the base effect created by the high production level in the second quarter of 2004 is expected to manifest its consequences as of March, leading to a decline in annual growth rates of industrial production.

Table 3.1.1. GDP Developments by Expenditure Side
(Annual percentage change)

	2003					2004				
	I	II	III	IV	Annual	I	II	III	IV	Annual
1- Consumption Expenditures	6.9	2.3	5.2	8.0	5.6	11.6	15.4	5.9	4.7	9.0
Public	-2.3	-2.0	- .7	-4.2	-2.4	2.6	-7.8	-7.0	11.1	0.5
Private	7.8	2.9	5.8	10.3	6.6	12.4	18.4	7.3	3.6	10.1
Durable Goods	24.7	10.6	11.4	49.5	24.0	48.0	61.4	28.9	-5.7	29.7
Services	9.6	5.1	7.6	7.9	7.5	11.6	15.3	6.1	6.6	9.3
Food and Beverages	4.4	4.1	5.7	1.0	4.1	5.3	2.6	0.0	5.4	2.8
Semi-dur. & Non-dur. Cons. Exp.	4.7	-4.5	3.7	3.8	2.2	8.2	36.8	18.3	16.3	18.8
2- Fixed capital formation	11.7	6.4	3.0	19.2	10.0	57.6	47.4	26.1	11.2	32.4
Public	-34.8	-14.6	-22.7	5.0	-11.5	-5.9	-8.7	-10.8	0.9	-4.7
Private	22.5	14.2	16.4	30.1	20.3	65.5	63.1	38.9	17.7	45.5
3- Stock Change*	3.6	5.5	2.2	1.2	3.0	2.5	1.4	-1.2	2.5	1.1
4- Exports of Goods and Services	14.5	12.3	19.4	16.9	16.0	10.9	17.2	8.2	14.4	12.5
5- Imports of Goods and Services	22.0	24.7	28.3	33.0	27.1	31.3	32.7	16.1	19.6	24.7
6- Total Domestic Demand	10.9	8.5	7.0	11.3	9.3	20.6	21.4	8.1	8.5	14.1
7- Total Final Domestic Demand	7.7	3.2	4.7	10.6	6.5	19.8	22.9	9.9	6.3	14.1
8- GDP (Expenditure Side)	8.1	3.9	5.5	6.1	5.8	11.8	14.4	5.3	6.3	9.0

*Contribution to GDP growth, percent
Source: SIS.

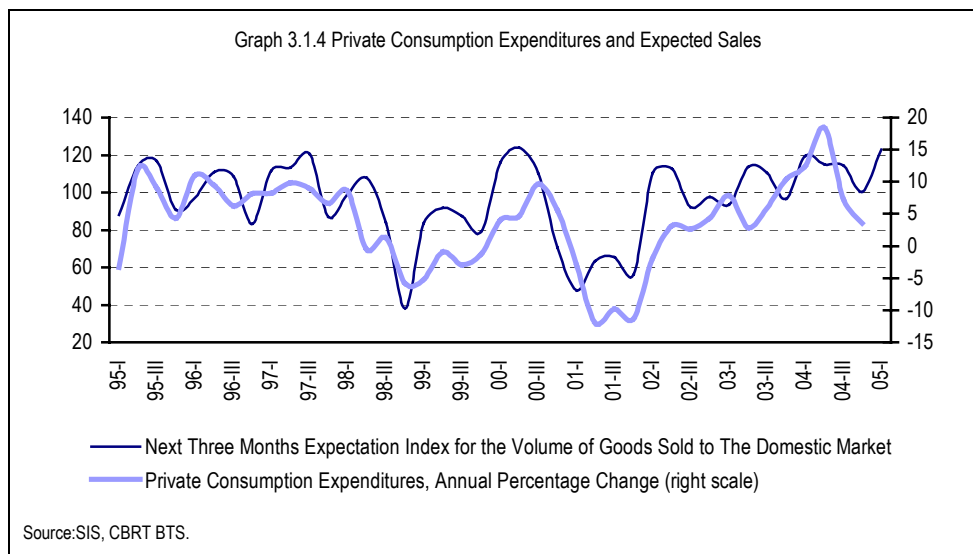
Analyzing economic growth from the demand side, the slowdown in domestic demand that started in the third quarter of 2004 also continued in the last quarter of the year. In the light of seasonally adjusted data, private consumption expenditure and total final domestic demand decreased compared to the preceding period. Moreover, for the first time in the last two years, the contribution of private expenditure to economic growth remained below the growth rate of the Gross Domestic Product (GDP) in the last quarter of the year. During this period, despite the positive contribution of public expenditure to growth, total final domestic demand grew at the same rate as the GDP, contrary to previous periods. This development is considered to be a sign of a slowdown in narrowing of the demand gap in the economy (Graph 3.1.3).



An analysis of private consumption expenditures in terms of subgroups shows that the demand composition changed in the last quarter of 2004 compared to previous periods. Expenditures on durable goods, which were among the leading catalysts of growth in the first nine months of the year, decreased in the last quarter of the year compared to the same period of the previous year (Table 3.1.1). Also during this period, expenditure on semi-durable, non-durable goods and food became the main factors determining the growth in private consumption expenditure. The decrease in expenditure on durable goods and weak pattern of consumption goods expenditure (excluding durables) restrained pressure on prices.

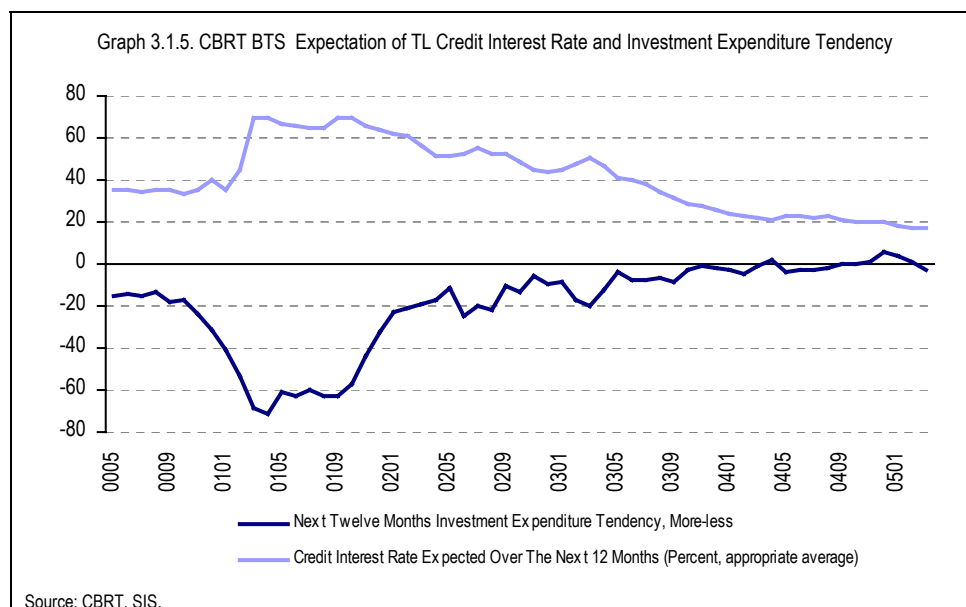
The above-mentioned tendency in the consumption composition is also believed to have continued in the first quarter of 2005. The most updated data point out that the sluggishness in demand for durable goods, particularly for automobiles, continues. According to data announced by the Automotive Manufacturers Association (AMA), domestic automobile sales decreased by 25.9 percent in the January–March 2005 period compared to the same period of the previous year. Meanwhile, domestic white goods sales increased by 4.8 percent in the January–February period compared to the same period of the previous year. In addition, the developments in the subgroups of industrial production indicate that domestic demand is mainly based on investment goods, and the demand for consumption goods grows in a controlled manner. The specified structure of the domestic demand composition

contributes to the simultaneous sustenance of the disinflation and growth. Continuance of the disinflation process and increased confidence in the economy will have a favorable influence on consumer confidence in the upcoming period. In this respect, domestic sales expectations of manufacturing industry firms for the next quarter improved in the first quarter of 2005 (Graph 3.1.4).



Private investment expenditure continued to increase in the last quarter of 2004, though at a slower pace, compared to the first nine months of the year. Both machinery-equipment and building construction investments were instrumental in the 17.7 percent growth in private investment expenditure during this period compared to the same period of the previous year. Besides, data released by the SIS suggest that the construction permits granted for industrial buildings (area, square meter) recorded a high-rated increase of 27.7 percent in the last quarter of 2004 compared to the same period of the previous year. While the continuance of machinery-equipment investments supports productivity increases, the steady growth observed in 2004 in building construction investments enables the establishment of new production units and the increase of the aggregate supply potential of the economy. In other words, the ongoing growth in investment expenditure raises the potential production level and enables rapid, yet non-inflationary growth.

Ongoing growth in investment expenditure raises the potential production level and enables rapid, yet non-inflationary growth.

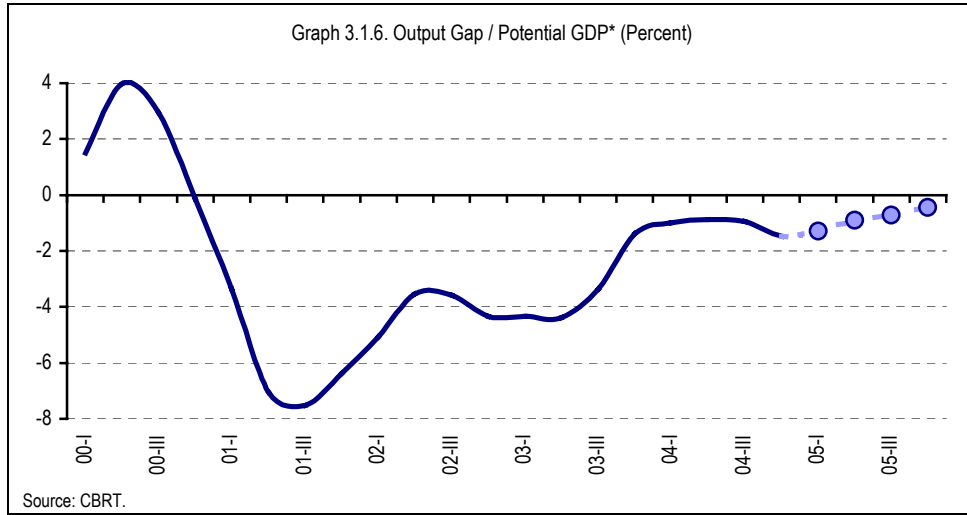


Indicators for the first quarter of 2005 point to the continuing increase in investment expenditure. Machinery–equipment production increased by 15.3 percent in the January–February period compared to the same period of the previous year and the annual growth rate of capital goods imports was recorded as 10.7 percent. Besides, domestic sales of light commercial vehicles (pickup trucks+ minibuses) rose by 4.8 percent in the first quarter of the year compared to the same period of the previous year. Meanwhile, as of March 2005, while the expectation of interest rates on credits, an indicator of the CBRT Business Tendency Survey (BTS), maintains its downward trend, the investment expenditure tendency preserves its high level (Graph 3.1.5). All these signal that also in 2005, private investment expenditures will be one of the main determinants of growth. Besides these factors, although having been predicted to decrease in 2005 compared to the previous year due to the base effect, the growth rate of private investment expenditure is expected to continue to be one of the main determining factors of overall economic growth rate.

No short-term demand-push pressure is expected on prices, due to moderate domestic demand growth, the prevailing increase in investment expenditure, and the fact that the rates of capacity utilization have not reached very high levels yet.

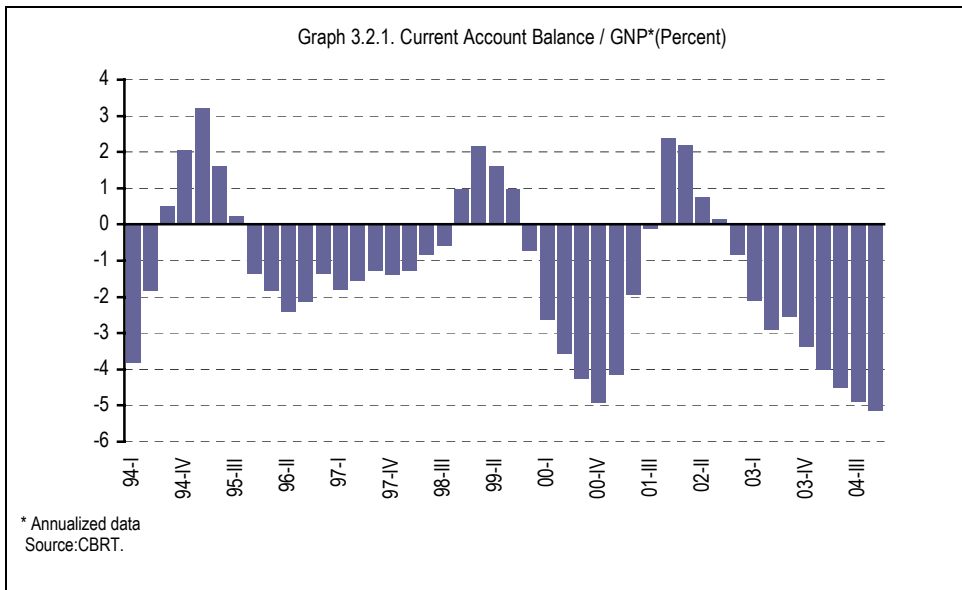
In the light of these developments, the prevailing demand conditions are not believed to be at a level to exert pressure on prices in the short run. No short-term demand-push pressure is expected on prices due to moderate domestic demand growth, the prevailing increase in investment expenditure, and the fact that the rates of capacity utilization have not reached very high levels yet. Furthermore, estimations for the

output gap show that the production level of the Turkish economy in 2005 will not be at a level to jeopardize the disinflation process (Graph 3.1.6).



3.2. External Demand

In 2004, the current account balance produced a deficit of US dollar 15.6 billion and the ratio of the deficit to GNP was realized as 5.1 percent (Graph 3.2.1). As of February 2005, the current account deficit was US dollar 3.8 billion.



According to the data announced by the SIS, exports, which increased by 33.5 percent in 2004, rose by 25.2 percent in the first two months of 2005. Data released by the Turkish Exporters' Assembly point to a 25.1 percent increase in exports in March. The favorable level of real unit wages enabled the firms to maintain competitiveness and the ongoing increases in exports.

Despite the slowdown in the domestic demand growth, the ongoing high-rated increases in exports paved the way for the continuation of the increase in imports led by the imports of intermediate goods. According to data released by the SIS, the annual rate of growth for total imports was 23 percent in the first two months of 2005. Data announced by the Ministry of Finance, pertaining to VAT on imports show that the increase in imports also continued in March. In the first two months of 2005, the annual rate of increase for intermediate goods imports was 29.4 percent while the corresponding figure for consumption goods imports was 3.4 percent. These data reinforce the assessment that the decline in the growth rate of private consumption expenditure also continued in the first two months of 2005.

3.3. Costs

Employment in the manufacturing industry increased by 2.2 percent in the last quarter of 2004, compared to the same period of the previous year. Real wages per hour of production and productivity per hour of production indices rose by 1.6 percent in the said period (Table 3.3.1).

Table 3.3.1. Employment, Real Wage and Productivity Developments in the Manufacturing Industry
(Percentage change over the same period of the previous year)

	2002		2003					2004				
	Annual	I	II	III	IV	Annual	I	II	III	IV	Annual	
Employment⁽¹⁾	0.6	5.1	1.8	1.4	-0.5	1.8	0.7	2.7	2.2	2.2	2.0	
Public	-9.1	-4.1	-6.5	-5.3	-10.7	-6.8	-13.6	-11.0	-9.6	-9.7	-11.0	
Private	2.3	6.3	3.1	2.4	0.9	3.1	2.4	4.5	3.7	3.6	3.6	
Wage⁽²⁾	-5.4	-0.9	-5.3	-3.8	2.4	-1.9	0.4	5.2	3.0	1.6	2.5	
Public	1.4	-2.5	-8.9	-8.5	-1.1	-5.3	2.9	7.7	5.5	2.9	4.7	
Private	-4.2	0.9	-2.7	-1.1	5.1	0.6	2.8	7.7	4.8	3.9	4.8	
Productivity⁽³⁾	8.6	5.1	3.5	8.6	11.4	7.2	8.5	13.6	6.4	1.6	7.3	
Public	16.4	4.8	8.2	8.4	11.3	8.1	14.8	13.1	5.6	8.5	10.5	
Private	7.8	6.0	3.5	9.4	12.4	7.9	9.0	15.0	7.6	1.2	8.0	
Earnings⁽⁴⁾	-8.0	-5.4	-10.6	-8.2	-0.9	-6.3	1.8	3.7	0.9	-0.5	1.3	
Public	-2.1	-3.5	-12.2	-11.0	4.1	-5.6	0.6	9.2	0.9	2.5	3.2	
Private	-6.8	-4.2	-8.4	-5.8	-0.1	-4.7	5.5	5.8	3.9	2.3	4.3	

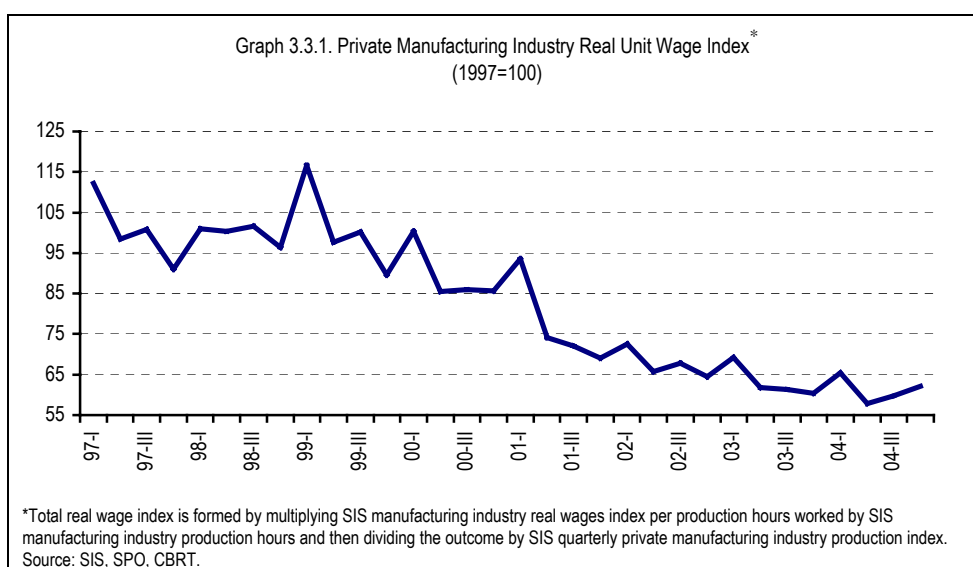
(1) SIS, Manufacturing industry production worker index, 1997=100

(2) SIS, Manufacturing industry real wages index per production hours worked, 1997=100

(3) SIS, Manufacturing industry partial productivity index per production hours worked, 1997=100

(4) SIS, Manufacturing industry real earnings index per production worker, 1997=100

Despite its increase by 2.8 points compared to the same period of the previous year, the real unit wage index, denoted as the ratio of real wages in the private manufacturing industry to partial labor productivity, is still at low levels (Graph 3.3.1). This favorable state of real unit wages not only prevents production increases to form capacity-side pressures on prices, but is also one of the most significant determinants of the outstanding exports performance.



Data for January and February show that a higher rate of increase will be recorded in industrial production in the first quarter of 2005 compared to the last quarter of 2004. Yet, productivity increases are believed to be limited due to the continuing rise in employment.

The public sector income policy for 2005 was established in conformity with the inflation target, and the rate of increase in the minimum wage was determined accordingly. This favorably affected expectations on price developments. Furthermore, due the fact that the public sector leads the private sector in determining wage increases, the increase in real wages will be limited.

In 2005, the increase in productivity is believed to pursue a parallel course to the increase in the real wages. Hence, the decline in real unit wages is predicted to cease in 2005. However, taking into account the downward trend observed in real unit wages during the last three years, firms are believed to maintain cost advantages and no pressure stemming from labor costs is expected on prices in 2005.

Taking into account the downward trend observed in real unit wages in the last three years, firms are believed to maintain cost advantages and no pressure stemming from labor costs is expected on prices in 2005.

The strong stance of the Turkish lira vis-à-vis foreign currencies pushes down the prices of imported raw materials and investment goods in terms of the national currency, and thus continues to prevent the formation of cost-push pressures on prices. However, the rising tendency in international markets of oil and metal prices used as basic raw materials in industrial production also continues in the first months of 2005 (Table 3.3.2). The likelihood that these unfavorable developments in international markets might continue in the coming periods as well poses a risk to inflation in all cases.

Table 3.3.2. Selected Indicators of Production Costs

	2003					2004				2005	
	I	II	III	IV	Annual	I	II	III	IV	Annual	I
Import Price Index	98.2	100.0	98.8	103.1	100.0	110.8	112.3	115.9	122.8	115.1	125.0 ⁽¹⁾
Crude Oil Prices (\$/Barrel)	28.7	24.7	26.5	28.0	27.0	30.0	32.0	36.7	39.6	34.6	41.6 ⁽²⁾
Metal Prices Index	92.7	93.0	97.9	109.3	98.2	130.0	130.2	133.8	141.9	134.0	-

(1) As of February 2005.

(2) February and March figures are forecasted values.

Source: SIS, SPO, IFS.

4. Developments in Financial Markets

The CBRT has decided to launch the inflation targeting strategy in 2006, given the fact that important steps have been taken in order to fulfill the necessary conditions for the success of inflation targeting following the adoption of a floating exchange rate regime. The design and implementation of inflation targeting can vary in each country, according to the country's macroeconomic and institutional structure. However, in any case, price stability is the primary objective of monetary policy and no other target is set for any other variable.

The CBRT has decided to launch the inflation targeting strategy in 2006, given the fact that important steps have been taken in order to fulfill the necessary conditions for the success of inflation targeting following the adoption of a floating exchange rate regime.

The CBRT attaches great importance to eliminating factors that undermine the effectiveness of monetary policy and create uncertainties about the functioning of the transmission mechanism during the transition to formal inflation targeting. Those uncertainties are expressed in the risk premium, which has a varying time nature and is determined primarily by public debt dynamics. The risk premium not only blurs the relationship between short-term and long-term interest rates but also causes fluctuations in exchange rates and hence makes the course of inflation less predictable.

Under the inflation targeting strategy, the CBRT explicitly uses short-term interest rates as the monetary policy instrument and has no target for exchange rates. Meanwhile, the uncertainties and potential damage on the economy that would be caused by any potential volatility stemming from the changing roles of short and long-term exchange rate dynamics under the floating exchange rate regime, justify CBRT's interventions in the foreign exchange market. Taking these into account while analysing the monetary and exchange rate policies would help to mold expectations in a way to support the success of the macroeconomic policies implemented.

4.1 CBRT Monetary Policy

In the press release dated December 20, 2004 titled "Monetary and Exchange Rate Policies in 2005", the CBRT announced that the formal inflation targeting strategy would be launched in 2006, and 2005 would be a year of transition. Practices directed at making monetary policy decisions more predictable and more transparent come to the forefront in the transition period. Therefore, interest rate decisions are made by

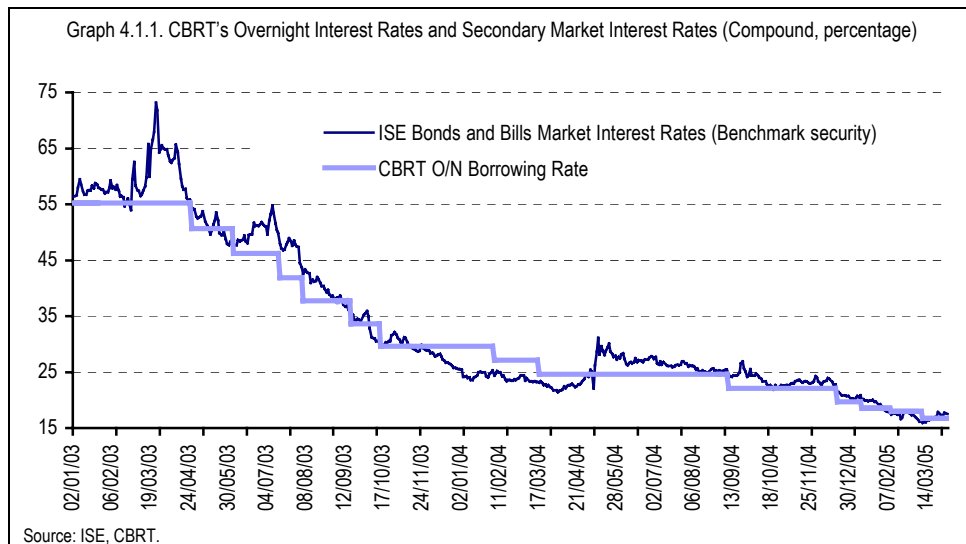
taking into account the evaluations of the Monetary Policy Committee on the economy, the meeting days of which are announced in advance, and the decisions are publicized in the morning of the following working day. In addition, a further press release is issued with the title of “Inflation and Outlook” within two days of the meeting, explaining the rationale behind the decision, as well as CBRT’s general evaluations of the economic outlook.

The interest rate policy of the CBRT is shaped in line with projections pertaining to the future trend of inflation. Therefore, coherent with the inflation target and projections, the CBRT may reduce, raise or maintain the interest rates.

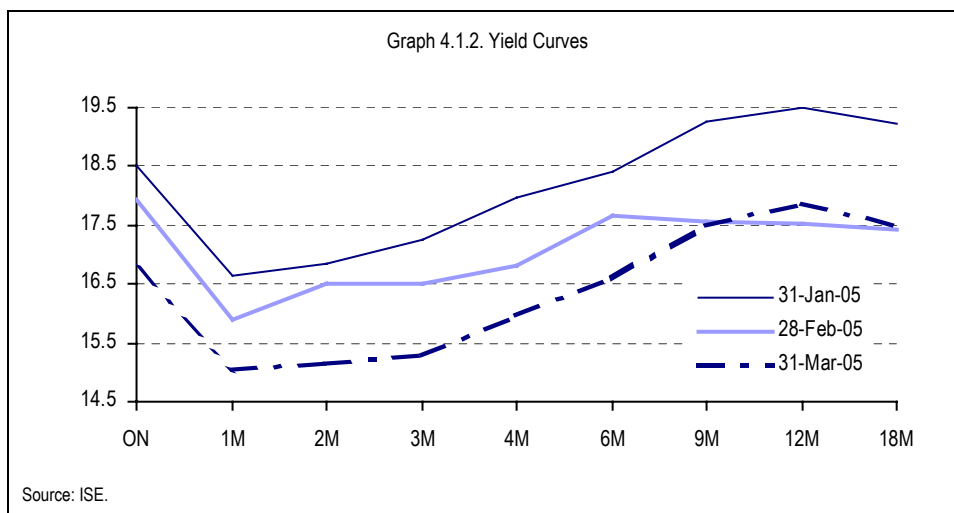
The interest rate policy of the CBRT is shaped in line with projections pertaining to the probable future course of inflation. Therefore, coherent with the inflation target and projections, the CBRT may reduce, raise or maintain interest rates after Monetary Policy Committee meetings. In order to be able to make projections about the future course of inflation, the CBRT takes into account the demand–supply balance, fiscal policy indicators, monetary indicators and credit aggregates, wage – employment – unit cost – production developments, public and private sector pricing behaviour, inflation expectations, exchange rates and the developments that could influence exchange rates, inflation projections and risk analysis of the Bank within the scope of potential exogenous shocks.

It is vital to understand the gist of monetary policy in order to be able to understand and interpret the interest rate decisions of the CBRT: CBRT’s monetary policy is formulated with a medium–term point of view. In other words, stance of the monetary policy is not influenced by temporary factors such as indirect taxes and changes in the indices, but it is determined by factors such as structural reforms, quality of fiscal discipline, general demand–supply balance and a sustained rise in productivity. That is because price stability can be achieved and sustained in the medium and long run by increasing the economy’s endurance when faced with the above–mentioned temporary factors that could pose risk in the short run. Actually, in the last three years, significant progress was made in fiscal and monetary discipline, expectations management and in terms of the credibility of policies, owing to the structural and institutional arrangements reducing the inefficiencies in the economy. Therefore, full comprehension of the points already mentioned is important for the success of future policies and the credibility of the Central Bank.

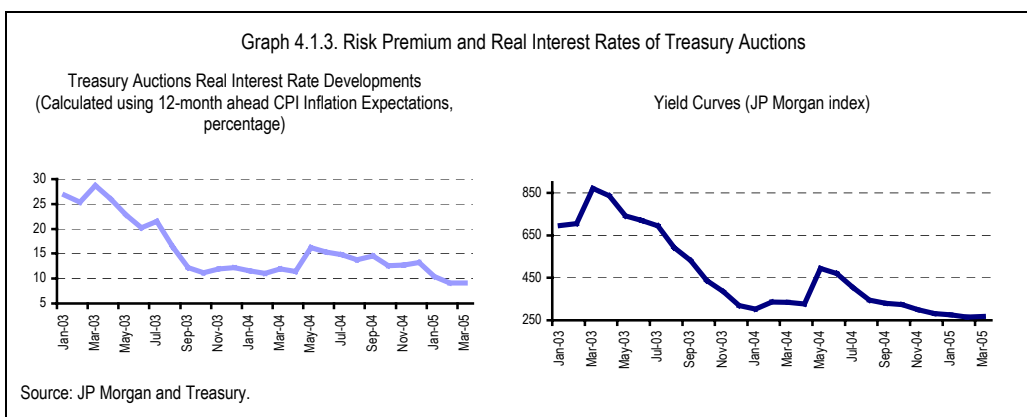
In the January–April 2005 period, the CBRT retained its cautious–optimistic stance with interest rate decisions, and eased the overnight borrowing rate by 0.5 points, reducing it to 15 percent on April 9, 2005. The CBRT predicts that there would be a slightly upward movement in inflation figures in the upcoming period due to the temporary rise in cost factors. Yet, under the assumption that the structural reforms would continue and that there would be no exogenous shocks, the CBRT believes that this rise would be a temporary one. Meanwhile, developments in the international markets and data pertaining to the last 3 months containing oblique signals about economic activity, led the CBRT to maintain its cautious stance about the future (Graph 4.1.1).



Parallel to the rapid transformation Turkey has been undergoing during the normalization period coupled with the increased macroeconomic stability, the monetary transmission mechanism is changing, too. To express this more clearly, uncertainties in the monetary transmission mechanism are gradually decreasing. The launch of formal inflation targeting in 2006 will help this mechanism become more effective. Although it has decreased substantially in the last three years, the role played by the high and volatile risk premium persists. Therefore, the current and future values of CBRT's short-term interest rates affect medium and long-term interest rates in a limited manner. This relationship will only become stronger when a permanent decline in risk premium is achieved. Within this framework, the importance of maintaining fiscal discipline and sustained structural reforms should be emphasized once again.



Yield curves showing interest rates of Government Domestic Borrowing Securities (GDBS) for different maturities at the end of each of the first three months of 2005 confirm the above-mentioned argument. Throughout the entire period analysed, it is observed that, parallel to the gradual decline in short-term interest rates, the yield curves pertaining to each maturity shifted downwards. Meanwhile, by March, longer term interest rates exceeded those of February due to concerns in March (Graph 4.1.2). These concerns were; the uncertainties pertaining to the outcome of the talks with the IMF and worries about the fact that the Federal Reserve Bank of USA (FED) would raise interest rates more than expected and hence international liquidity conditions would change to the disadvantage of developing countries. These developments, which were coupled with the unsolved structural problems, caused the risk premium and real interest rates to maintain their high levels (Graph 4.1.3).*



*In Graph 4.1.3, risk premium is the yield spread calculated as the difference between the interest rates applicable to the government papers issued abroad and the benchmark US bonds having the same maturity.

Recently, YTL-denominated securities with long maturities issued by international institutions have become another important factor for monetary policy. These institutions' demand for Treasury bonds with long maturities in order to cover up their short positions helps the Treasury borrow with longer maturities and also decreases the borrowing costs. These developments, which reduce fiscal dominance, are expected to increase the relative effectiveness of monetary policy. Developments regarding this issue are closely monitored and evaluated by the CBRT.

The rise in the volume of YTL-denominated securities issued by international institutions, which reduce fiscal dominance, are expected to increase the relative effectiveness of the monetary policy.

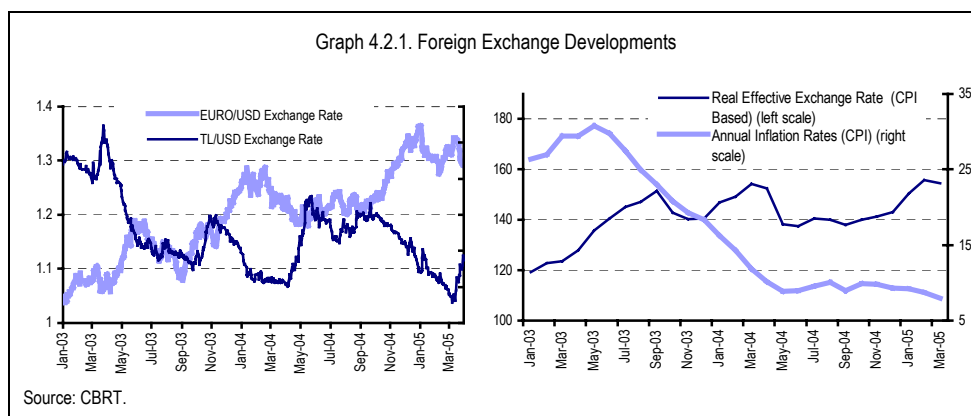
As the talks for a new stand-by agreement with the IMF have not yet been concluded, new performance criteria and indicative targets for 2005 have not yet been set. However, the CBRT closely followed the money demand developments in the first three months of 2005. Money demand has tended to increase in the said period. While the main reason of the increase in demand for money is believed to be the recovery in real economic activities, it is not possible to draw a clear-cut conclusion from the data available. It is predicted that the course of money demand will continue to be determined mainly by the developments in economic growth and domestic demand.

4.2. CBRT Exchange Rate Policy and Developments in Exchange Rates

Before moving on to exchange rate developments, it would be helpful to briefly repeat the main points about the floating exchange rate regime. Firstly, the CBRT does not have any target for exchange rates, and exchange rates are freely determined by supply-demand conditions in the market. These conditions are shaped by the developments in the economic program, public debt stock and risk premium, expectations, external developments and the behavior of market players in the short run. In the long run, factors affecting exchange rates are structural reforms and their impacts on productivity, the country's net foreign debt position, cyclical movements in the economy and economic fundamentals such as inflation and growth. Within this framework, the economic recovery powered by favorable developments in inflation, growth, productivity and the investment environment, improvements in the EU accession talks and steps taken towards a new agreement with the IMF along with the confidence in the economic program and policies have pushed up capital inflow in terms of portfolio investments and made reverse currency substitution more pronounced (Box 4.1). As a consequence of all these developments, the Turkish lira started to

Under the floating exchange rate regime, the CBRT has no target for the exchange rate level; exchange rates are freely determined by market conditions.

appreciate in 2004, especially as of the last quarter of the year. This trend, which accelerated in the first two months of 2005, started to slow down due to international liquidity conditions and changes in global risk perceptions in March (Graph 4.2.1).



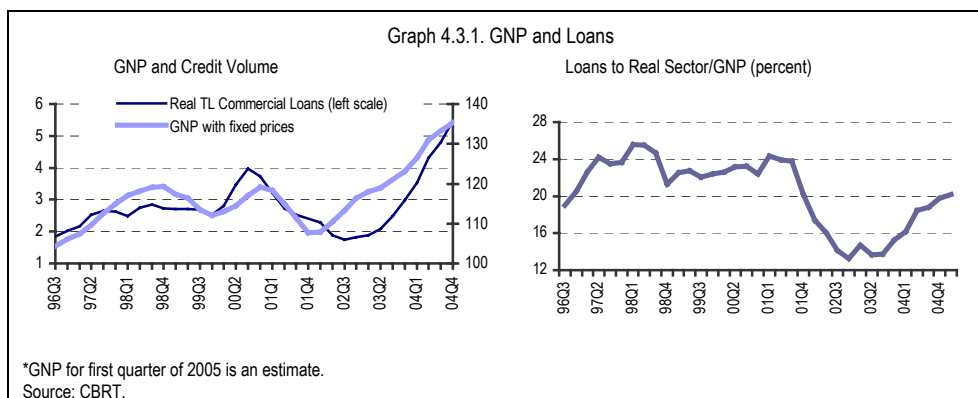
In the January-March period, besides the regular foreign exchange buying auctions aimed at building up reserves, the CBRT directly intervened in the markets on January 27th and on March 9th to buy foreign exchange.

There have been some fluctuations in the above-mentioned period from time to time. In the January-April period, besides the regular foreign exchange buying auctions aimed at building up reserves, the CBRT directly intervened in the markets on January 27th and on March 9th to buy foreign exchange.

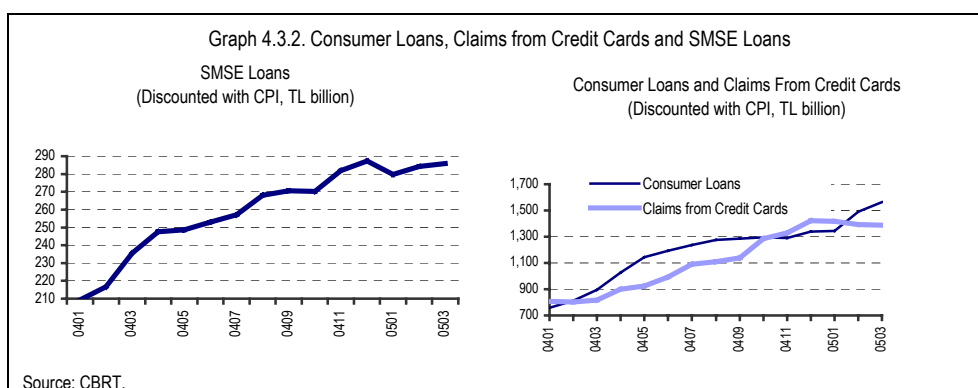
Lastly, it should be borne in mind that under a floating exchange rate regime, exchange rates pose risk for those economic agents that carry short foreign exchange positions. The Turkish Derivatives Exchange (TurkDEX), which started its operations in February 2005, provides economic agents with an opportunity for risk management. Extensive utilization of this opportunity would help decrease the fluctuations in exchange rates.

4.3. Developments in the Banking Sector and Credits

Despite the rise in oil prices in the first quarter, the EU accession talks played an important role in maintaining financial stability. The improvement in the financial structures of financial institutions and the corporate sector contributed to the stability in the markets. With the overall effect of single-digit figures attained in inflation, enhanced macroeconomic stability and a relative decline in fiscal pressure, the banks contributed to growth by extending credits to firms and households in Q1-2005, similar to the case in 2004 (Graph 4.3.1).



Banks that give weight to consumer loans support not only private investments, but also consumption. While loans extended to households increased in terms of consumer loans in the first quarter, the amount of claims from credit cards decreased. The rise in Loans for Small and Medium-Size Enterprises continued in the same period (Graph 4.3.2).



As a result of the measures taken to restrain the rapid rise in claims from consumer credits and credit cards, the rate of increase in consumer credits slowed down substantially. In the first quarter of 2005, the rise in consumer credits can be attributed mostly to housing credits (Table 4.3.1).

Table 4.3.1. Developments of Consumer Loans and Claims from Credit Cards
(Quarterly real percentage change)

	2004Q1	2004Q2	2004Q3	2004Q4	2005Q1
Consumer Loans	31,0	33,1	7,7	4,0	16,9
Housing Loans	49,4	51,1	12,4	9,1	32,8
Automobile Loans	29,9	34,3	4,5	0,7	-1,4
Other Loans	26,5	26,2	8,3	4,4	23,2
Claims from Credit Cards	9,9	21,6	14,6	25,1	-2,7

Source: CBRT.

The “Other credits” item under consumer credits displayed a rapid rise in February due to the credits extended by public banks for payment of interest to civil servants (Table 4.3.2). As part of these loans were used to pay credit card debts that have relatively high interest rates, the financial position of households was positively affected.

Table 4.3.2 Developments of Consumer Loans in Banking Groups
(Monthly nominal percentage change)

	Consumer Loans	Public Banks	Private Banks	Foreign Banks
October 2004	2.8	1.3	3.0	8.6
November 2004	1.4	1.0	1.1	5.1
December 2004	4.1	2.1	4.6	7.8
January 2005	1.0	-0.9	1.7	3.3
February 2005	10.9	26.3	3.3	6.5
March 2005	5.3	2.0	6.9	9.7

Source: CBRT.

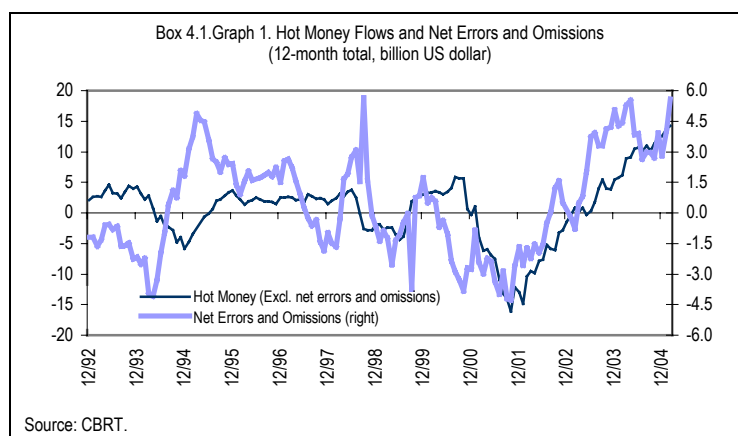
The rates of increase in credit card and consumer credit utilization are closely monitored for the sake of attaining sustained decline in inflation and maintaining financial stability.

The amount of equity capital the banks are required to keep in provision for their credit card limits was increased in November. This development is expected to limit the rise in the credit volume of banks in 2005. As a result, the rate of increase in claims from consumer credits and credit cards are not expected to jeopardize the future trend of inflation and pose risk to financial stability. Therefore, the impact of the rise in credit card and consumer credit utilization on domestic demand, inflation and current account deficit will continue to be closely monitored.

The restructuring efforts, which were initiated following the financial crisis in 2000 and 2001, with the aim of enhancing supervision of the financial system, continued with the Banking Regulation and Supervision Agency (BRSA’s) initiative to bear more responsibilities independent from political authority and to attach more importance to risk management and control in the banking system, and this became an important factor in supporting financial stability. Moreover, strengthening the financial structures of financial institutions is important for macroeconomic stability. Meanwhile, financial assets that are highly vulnerable to fluctuations in the market, which are becoming more widely used both by residents living abroad and the domestic non-banking sector act as a shock absorber for the financial system. The transfer of risks normally borne by the financial system to the non-banking sector enhances the stability and strength of the financial system.

BOX 4.1: HOT MONEY FLOWS IN TURKEY

Although it does not exist a commonly accepted definition, the notion of "hot money" can be described as the capital flows that respond immediately to the changes in the expected rates of return and risks.¹ Hence, the suddenness of hot money flows is more important than the quantity of hot money. In this framework, though short-term capital flows are generally used as a substitute for hot money, the two are not identical: Short-term capital flows can include real sector credit transactions; however, items such as commercial credits are not included in the definition of hot money.² Besides, portfolio investments, which are composed of equity securities and government's domestic borrowing securities - making up the greatest share-, and which do not appear under short-term capital items, and the net errors and omissions item are also included in the definition of hot money.³ The approach describing the net errors and omissions item as hot money arises from the assumption that the specified item shows the unregistered capital flows. As a matter of fact, trends observed in the net errors and omissions item during the crisis and stability periods support this approach (Graph 1).⁴ On the other hand, balance of payments statistics provide data pertaining to changes in the foreign exchange assets of banks via the foreign exchange flows of those banks' correspondents, while they also include data pertaining to changes in the official reserves via the foreign exchange flows of the Central Bank's correspondents. However, changes in the foreign exchange assets of the non-banking private sector cannot be fully monitored. Hence, it is believed that the changes in the foreign exchange assets of the non-banking private sector are also reflected to a great extent in the net errors and omissions item. Taking this fact into consideration, it is assumed that the net errors and omissions item is composed of residents' transactions.⁵

**Hot money flows in Turkey**

In the framework of the above-mentioned definitions; portfolio investments, short-term capital flows and the net errors and omissions item are included in the definition of hot money while calculating the amount of hot money in Turkey. The items taken from the balance of payments statistics are listed below:⁶

Hot Money =**Portfolio Investments**

- Purchases/sales of equity securities by non-residents within the country,
- Purchases/sales of government's domestic borrowing securities by non-residents within the country,

¹ Chang, P. H. Kevin, Stijn Claessens and Robert E. Cumby, 1997, "Conceptual and Methodological Issues in the Measurement of Capital Flight," International Journal of Economics and Finance, Vol. 2

² The "Commercial Credits" item, included in the "Assets" and "Liabilities" part of "Other Investments", refers to timed foreign trade transactions, contrary to other credit transactions. For this reason, the definition of hot money does not cover the short-term commercial credits item, which is directly related with foreign trade transactions.

³ Chang K. et al, 1997, *ibid.*; Altinkemer, Melike, 1995, "Capital Flows: The Turkish Case", CBRT Discussion Paper No.9601; Schneider, Benu, 2001, "Measuring Capital Flight: Estimates and Interpretations," Overseas Development Institute; Boratav, Korkut and Erinç Yeldan, 2001, "Turkey: 1980-2000: Financial Liberalization, Macroeconomic (In)-Stability, and Patterns of Distribution", CEPA, New School University, mimeo.

⁴ In definition, the net errors and omissions item equalizes the total of the current account and net capital flows with the change in reserves due to unregistered transactions or transactions registered with omissions/errors. Since the balance of payments accounts are formed according to the double-entry system, the difference between the asset and liability entries appears as net errors and omissions on the balance of payments accounts. For this reason, it may be misleading to assume that the net errors and omissions item entirely reflects unregistered capital flows.

⁵ In balance of payments presentation, the "other sectors" item on the assets side of other investments is calculated as a certain ratio of shuttle trade revenues. The amount corresponding to this rate is assumed to be held in cash rather than being deposited in a bank or any institution. For this reason, the said item may be misleading.

⁶ In the framework of balance of payments methodology, the notion of "non-residents" in the definitions refers to "non-residents living abroad". The classification is based on the country of residence rather than nationality.

+ Short-term Capital Flows

- Short-term credits extended abroad by banks,
- Short-term credit drawings of resident banks and non-bank private sector from abroad,
- Short-term deposits of non-residents in resident banks,

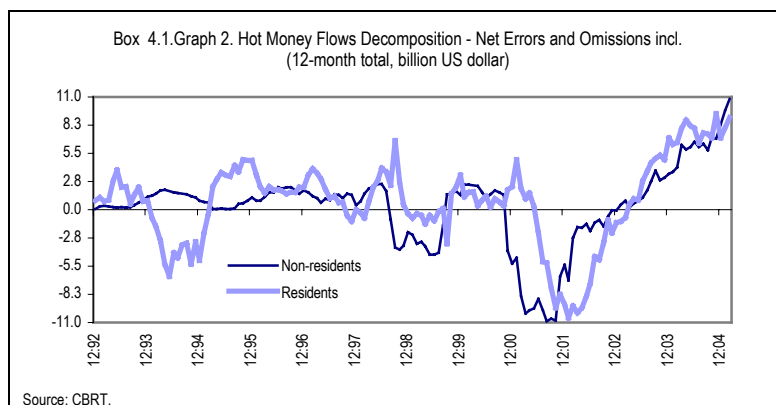
+ Net Errors and Omissions

According to this definition, as of February 2005, hot money inflow to Turkey amounted to net USD 19.8 billion annually. This amount drops to net USD 14.2 billion when the net errors and omissions item is excluded. USD 10.8 billion of this inflow stems from non-residents' transactions, while USD 9 billion belongs to the transactions of residents (Table 1).

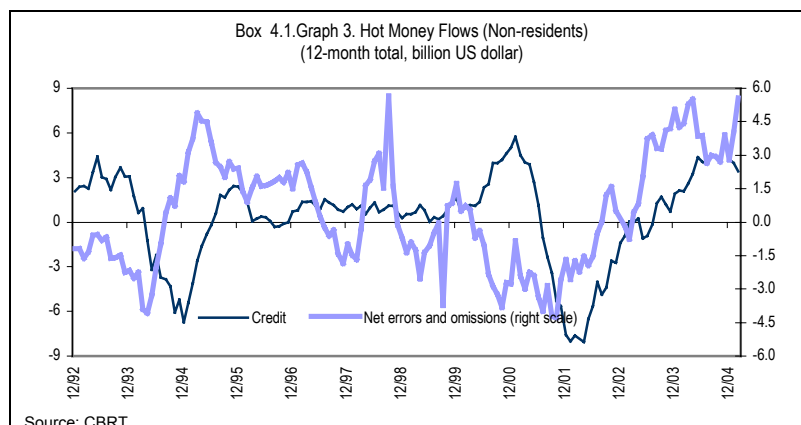
Box 4.1. Table.1. Hot Money Flows in Turkey
(As of February 2005, 12-month period, billion US dollar)

Portfolio	Non-residents	Residents	TOTAL
Credits and deposits	10.3	0.0	10.3
Net errors and omissions	0.5	3.4	3.9
Net errors and omissions	0.0	5.6	5.6
TOTAL	10.8	9.0	19.8

Source: CBRT.



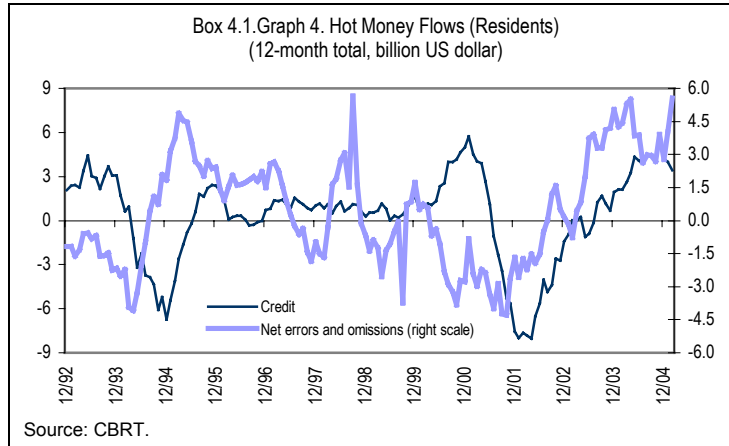
Hot money flows stemming from the transactions of non-residents are composed of purchases of securities in the ISE as well as government's domestic borrowing securities, and short-term deposit accounts opened in banks. Portfolio investments of non-residents have been following an inflow trend since 2002, and this trend has gained momentum starting from the last quarter 2004.



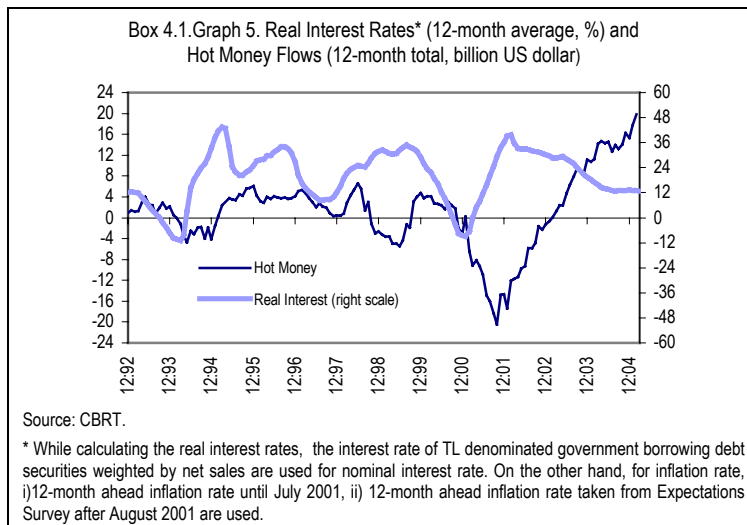
Meanwhile, hot money flows created by the transactions of residents are composed of short-term credit transactions, and the net errors and omissions item that is assumed to show the unidentified flows in records. Short-term credits used by the private sector make up a small share in the credit items. The share of credits extended by banks abroad is also small, and these credits follow a relatively stable trend. Hence, credit-oriented hot money flows are essentially composed of the short-term credits received by banks from abroad.

Factors determining international capital flows

Factors determining international capital flows are divided into two main groups, namely the "push factors" originating from international liquidity conditions, and national "pull factors". In other words, in cases where international interest rates are low, an increase in the capital flows towards countries with relatively higher interest rates is an example of push factors. Meanwhile, national factors such as the general macroeconomic condition and the exchange rate regime of the capital-attracting country provide examples of pull factors. The specified factors determine the direction and level of capital flows.



Fixed exchange rate regimes, in which the central bank undertakes to maintain a specific exchange rate level, significantly reduce exchange rate risk for investors. For this reason, non-residents are more enthusiastic about utilizing short-term arbitrage facilities in fixed exchange rate regimes rather than floating exchange rate regimes, while residents tend to increase their foreign exchange short positions. However, in a floating exchange rate regime, the exchange rate risk in the markets increases the cost of hot money outflow, and hence hot money inflows are expected to remain at low levels in floating exchange rate regime economies. Contrary to this expectation, hot money inflows have recently increased in Turkey despite the implementation of a floating exchange rate regime and the significant decline in real interest rates (Graph 5). The achieved macroeconomic stability, decrease in the fragility of the banking sector, high level of reserves and increased confidence of investors are believed to be the main factors in this development. In addition, favourable developments in the relations with the EU and removal of the uncertainties about the new stand-by program signed with the IMF play a significant role in the increase of hot money inflows originating from the transactions of non-residents. As a matter of fact, in the December 2004-February 2005 period alone, hot money net inflows amounted to a total of USD 7 billion.



5. Public Finance

One of the main elements of stability programs, which aim to achieve price stability and sustainable growth, is to establish and sustain fiscal discipline. As an indicator of fiscal discipline, primary surplus pursued a favorable course in the January–March 2005 period. Accordingly, the consolidated budget primary balance provided a surplus of YTL 8.9 billion in this period (Table 5.1). This amount corresponds to 32.8 percent of the budget target for 2005.

Consolidated budget primary surplus pursued a favorable course in the first quarter of 2005.

Table 5.1. Consolidated Budget Figures

	2005 Jan- March Realization (Billion YTL)	2005 Target (Billion YTL)	The Ratio of Realization to Target (Percent)
Revenues	28.3	126.5	22.4
Tax Revenues	23.0	106.6	21.6
Direct Tax Revenues	7.1	27.7	25.7
Indirect Tax Revenues	15.9	78.9	20.2
Expenditures	31.3	155.6	20.1
Non-Interest Expenditures	19.4	99.2	19.5
Personnel	8.2	31.9	25.6
Current Transfers	8.0	32.5	24.6
Interest Expenditures	11.9	56.4	21.2
Budget Balance	-3.0	-29.1	10.3
Primary Balance	8.9	27.3	32.8

Source: Ministry of Finance.

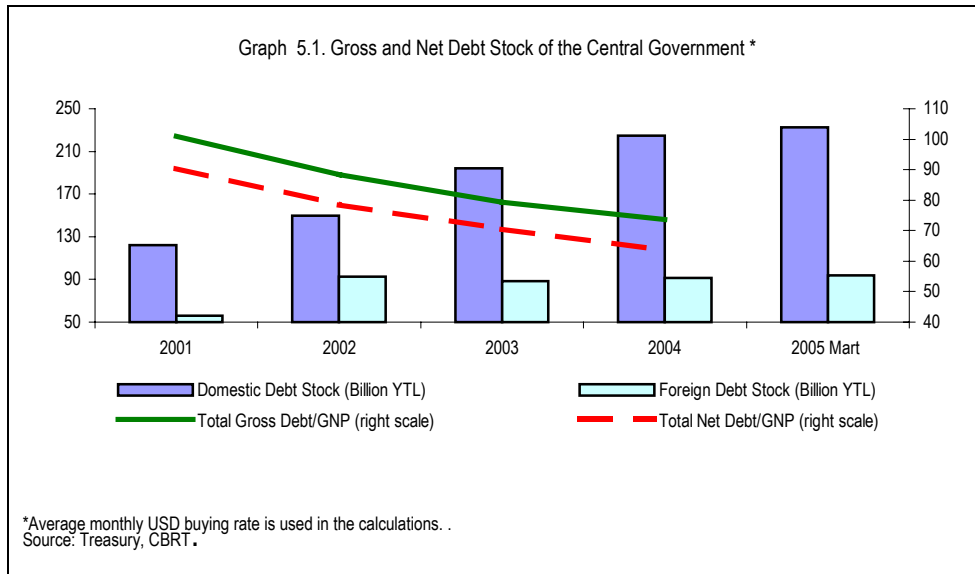
Achieving fiscal adjustment is important on its own. However, the main factor that will increase the effectiveness of monetary policy in achieving and maintaining price stability is the sustainability of fiscal adjustment. The fact that adopted fiscal policy, which aims to achieve primary surplus, is mainly based on indirect taxes and the uncontrollable nature of some expenditure items, such as social security, point at the importance of structural reforms to be made on tax, public expenditures and social security in order to maintain fiscal discipline. In this framework, to achieve public fiscal discipline, it is highly crucial that the laws on the social security reform should be put into implementation without delay. In previous years, important steps were taken in fiscal policy in terms of transparency, accountability and budget implementation. However, there is more distance to be covered regarding expenditure-curbing and tax-increasing reforms. The most important factor, which determines the structure of public revenues and expenditures and plays a complementary role in fiscal policies, is the extent of the informal economy in Turkey. Hence, serious steps should be taken to fight against informal economy.

Prompt implementation of reforms for establishing fiscal discipline and the fight against the informal economy are the key factors in sustaining fiscal adjustment.

5.1. Developments in Debt Stock

Significant gains were attained with respect to debt stock, however the vulnerability of the stock persists.

One of the most important gains of the current economic program has been the significant decline in the ratio of debt stock to GNP.* The share of consolidated budget gross debt stock in the GNP, which was 100.9 percent in 2001, dropped to 73.7 percent in 2004 (Graph 5.1). The same trend was observed in net debt stock. Factors underlying this significant decline were; the high level of primary surplus, the decrease in nominal and real interest rates stemming from the confidence established as a result of the economic program, even more importantly, the appreciation of the YTL, and lastly, economic growth. Despite the significant decline observed, the level of debt stock is still high. Within this framework, a decline in the ratio of debt stock to GNP is very desirable as expectations pertaining to debt rollover are the main determinant of interest rates, inflation and growth dynamics. Prudent management of these expectations can only be achieved if the sole controllable variable, i.e. the primary surplus is attained, in other words, if fiscal discipline is sustained.



In addition to the size of the debt stock, the fact that fixed rate government securities have short maturities and that government bonds with long maturities have coupon payments every three months manifest the fact that fiscal pressure prevails, although it has eased compared to previous periods (Graph 5.2, Table 5.2). Meanwhile, although there are significant improvements in the debt stock structure in terms of borrowing instruments, its sensitivity to exchange rates and interest

Structure of the debt stock improved substantially. However, it is still sensitive to interest rates and exchange rates.

* Nominal gross total debt stock has an increasing tendency as a consequence of the long term borrowing at high interest rates in the previous periods.

rates continues. Actually, as of March 2005, some 45 percent of the consolidated domestic debt stock is composed of Foreign Exchange (FX)-linked or floating rate borrowing instruments. Such a structure has an adverse impact on not only exchange rates and interest rates, but also the shaping of inflation expectations. Hence, it undermines the effectiveness of monetary policy.

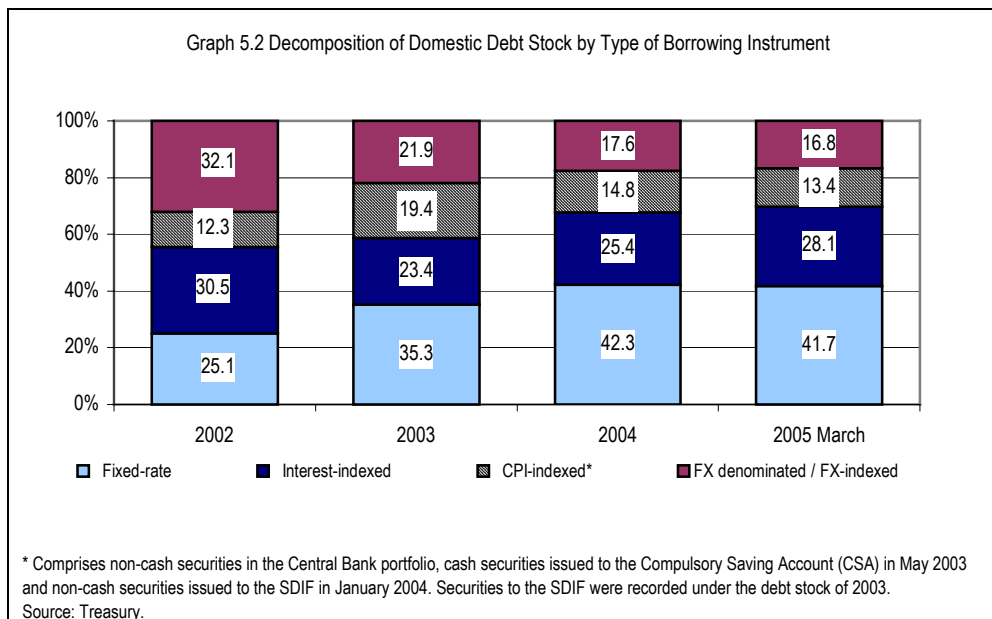


Table 5.2. Maturity Structure of the Domestic Debt Stock

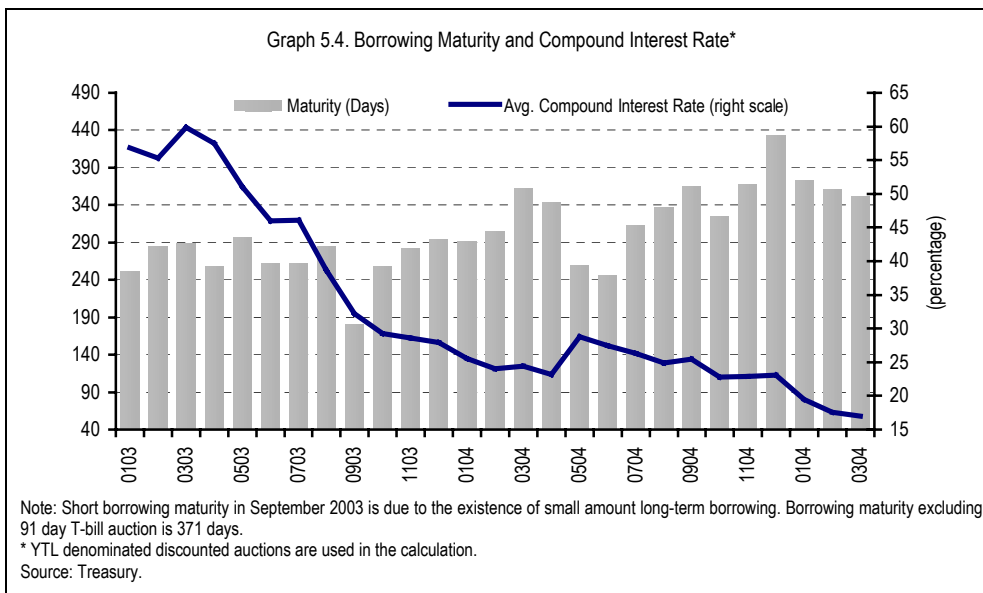
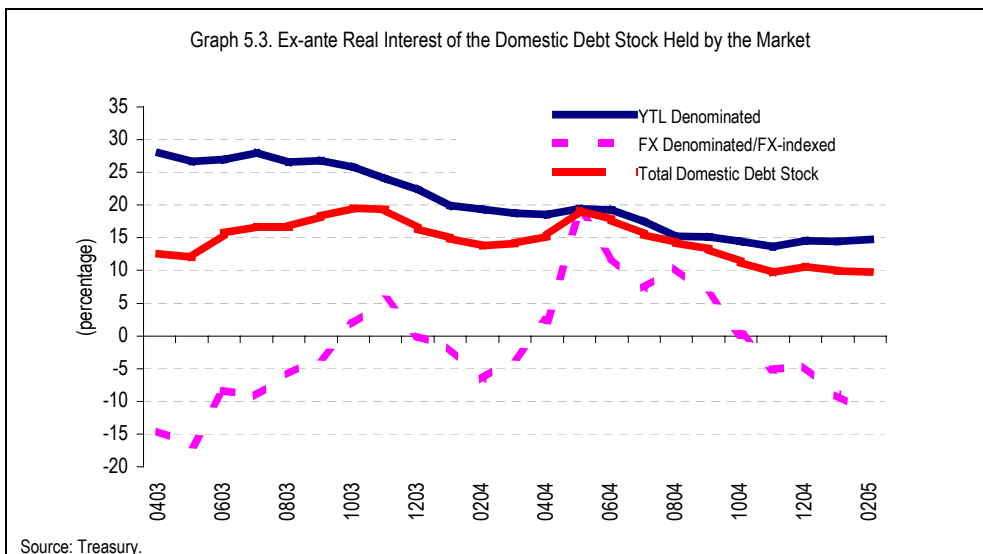
	2003		2004		2005 (Jan-March)	
	Maturity (Month)	Share (Percentage)	Maturity (Month)	Share (Percentage)	Maturity (Month)	Share (Percentage)
Total Borrowing	18.1	100	17.3	100	26.3	100
Cash	14.7	90.5	15	96.1	26.3	100
T-bill	6.2	35.2	6.2	37.6	35.4	69.4
Bond	20.1	55.3	20.6	58.5	5.9	30.6
Non-Cash	50.4	9.5	73.9	3.9	0	0
Total Stock	25.1	100	20.6	100	20.9	100
Cash	12.4	67.1	11.8	73.8	13.6	75.0
Non-Cash	51.2	32.9	45.5	26.2	43.1	25.0

Source: Treasury.

Despite the significant decline observed, real interest rates still remain high.

The real interest rate on domestic debt held by market is the determinant of domestic debt stock developments. There has been substantial decline in real interest rates on domestic debt stock. The real interest rates of YTL-denominated bonds, which were around 28

percent in April 2003, dropped to 15 percent in February 2005 (Graph 5.3). Meanwhile, real interest rates of the debt stock that is sensitive to exchange rates have fluctuated along with the changes in exchange rates. However, when the economic growth rate is taken into account, it becomes evident that fiscal discipline and reforms will maintain their importance in the upcoming period for debt sustainability, as the real interest rates of YTL-denominated bonds are still high.



Meanwhile, when the borrowing policy is analyzed, it is observed that the average compound interest rate in the Treasury auctions, which was 28 percent for end-2003, decreased to 23 percent by the end of 2004 and was recorded as 17 percent in March 2005 (Graph 5.4). The decline in interest rates is expected to continue in the upcoming period. Positive expectations about inflation and a decline in real interest rates will become possible only if confidence in the sustainability of economic stability becomes stronger. In the January–March 2005 period, five-year government bonds with both floating and fixed interest rates were issued. At the same time, even if the issue of bonds with longer maturities in discounted auctions reduces the maturity risk exposure pertaining to the debt stock, the three-month T-bill reference auctions with high volumes, held for floating rate bonds, impede further decline in risks.

An attempt was made to extend maturities by issuing different borrowing instruments. Further extension of maturities is constrained by 3-month T-bill reference auctions.

The decline in FED interest rates since 2003 motivated capital inflow toward emerging markets. The resulting capital inflow to Turkey was instrumental in the reduction of interest rates and the appreciation of YTL. However, the March inflation figures in the USA, which came up higher than expected, signal that the FED will continue to raise interest rates. Moreover, the referendum to be held in France at the end of May, to vote on the EU constitution may initiate a debate on Turkey's accession to the EU. These emerge as risk factors that might have an adverse impact on interest rates and exchange rates, raise the cost of the debt stock and affect inflation expectations unfavorably. On the other hand, increased efforts regarding the privatization program and significant steps taken for a new stand-by agreement with the IMF, could help improve expectations.

In the upcoming period, the interest rate policy of the FED, developments in the EU and Turkey's privatization efforts will have a role in steering expectations.

6. Outlook

In this section, the outlook of inflation in the upcoming period is summarized with respect to supply and demand factors, cost factors, and monetary and fiscal discipline, in the light of the developments in the first four months of 2005.

6.1. Supply and Demand Factors

Growth in domestic demand slowed down substantially in the last quarter of 2004. In this period, the composition of consumption expenditure changed compared to previous periods and shifted from durable consumption goods to semi-durable and non-durable consumption goods. Compared to the first half of the year, the shift of consumption towards sectors other than durable goods is noteworthy. Meanwhile, public expenditure recorded a significant rise in this period. However, consumption is still at very low levels. Even though investment expenditure lost pace in the last quarter, machinery-equipment and construction investments continued to increase.

Automobile and white goods sales recorded in the first quarter of 2005, expectations for domestic sales and production for the next quarter as foreseen in the CBRT's BTS, and the data on industrial production and imports of investment goods point to a brisker domestic demand compared to end-2004. Furthermore, the recent decline in credit interest rates and the rise in money demand support this prediction. The said indicators also show that the investment expenditure tendency still maintains its historically high level and that private investment expenditure will be one of the main determinants of growth in 2005. In other words, the revival in domestic demand is forecasted to occur in a slower but more balanced and controlled fashion compared to the first half of 2004. Controlled increase in domestic demand coupled with the rise in investment expenditure prevents a supply/demand-oriented pressure on inflation in the short term. Moreover, 2005 predictions for the output gap indicate that production will not be at a level that would jeopardize the downward trend in inflation.

6.2. Cost Factors:

6.2. a. Wages

It was emphasized in previous reports and press releases that in the upcoming period, the rise in productivity would not support the downward trend in inflation as much as it did during the last four years. Actually, it is observed that real wages, which had been decreasing for quite some time, turned upwards in the last quarter of 2004. In this period, employment also increased and the growth rate of production slowed down. Hence, the rate of increase in labor productivity lost pace in some of the sub-sectors of the manufacturing industry. At this point, the levels of both real wages and unemployment rates are believed to prevent further slowdown in the short term. Furthermore, the rise in investment expenditure helps productivity increase, especially in technology-intensive sectors. The rise in real wages remains limited, as the private sector determines its wage policies in line with public sector wage policies, where the latter is consistent with the inflation target. Ensuring a continued increase in productivity is of critical importance not to lose sustainable growth rates in an environment of disinflation. For this reason, efforts to remove obstacles to investment and production should be intensified. That is to say, the reform process that has already been initiated should be implemented without interruption and taken to a higher level.

6.2.b. Commodity Prices

Crude oil prices displayed very high increases within the past year and reached their highest level since the 70s. These record highs were rather unexpected, and were caused by the fact that global supply fell short of meeting the rise in global demand. The temporary supply shocks and geopolitical uncertainties, which led to ambiguity in the oil production plans of the OPEC countries, and the historically low levels of production limited the oil supply. Robust economic growth in China and North America and adverse weather conditions in the northern hemisphere boosted the demand for oil.

Early indicators for 2005 show that supply and demand conditions are not likely to reach a balance that could bring down prices. North American and Chinese demand for crude oil and petroleum products continues to increase. The transaction price of crude oil for 2005 and 2006 is USD 52 on average, in the futures market. Moreover, the limited

production capacity and the ongoing rise in demand support the projections that crude oil prices will shift to a higher level. It is also predicted that the main oil-producing countries would be reluctant to increase production due to the rapid depletion of reserves and the never-ending geopolitical tensions in their geographic location.

In 2004, basic metal prices displayed high rates of increase along with crude oil prices. The main determinant of the hike in primary metal prices was China's growth performance. In 2005, the search for new mines is expected to ease the pressure on prices by increasing the supply. However, it is also predicted that basic metal prices will remain highly elevated in 2005, due to expectations that demand will be higher in 2005 than it was in 2004.

6.2.c. Exchange Rates

In a floating exchange rate regime, exchange rates fluctuate parallel to the developments in domestic and foreign markets. In the last quarter of 2004, the positive developments in macroeconomic indicators, attained under the current economic program, and Turkey's improving relations with the EU and the IMF built up confidence, increased capital inflow and encouraged reverse currency substitution. Therefore, the Turkish lira started to appreciate. This upward trend continued through the first quarter of 2005, however it was interrupted during the second quarter of the year, due to the liquidity conditions in international markets and the change in global risk perceptions. As a result of these developments, extreme fluctuations occurred occasionally, at which point the CBRT directly intervened in the foreign exchange market.

Portfolio inflows and direct foreign capital inflows are expected to continue along with the prevailing reforms and stability. Furthermore, in 2005, the current account deficit is likely to be financed smoothly, through short-term credits and long-term borrowing of the private sector. Meanwhile, the low rate of increase observed in the imports of consumer goods is considered to be a positive development. Therefore, the current account deficit is not expected to put pressure on inflation via exchange rates or expectations.

There is no doubt that exchange rates may fluctuate due to temporary shocks under a floating exchange rate regime. The point that should be emphasized here is that the said movements will be short-lived and

temporary, and their wavelength will be short. In this context, strengthening macroeconomic fundamentals without interruptions will be a prerequisite.

6.2.d. Pass-Through from Exchange Rates to Inflation

The nature of the effects of the latest exchange rate movements on inflation bears significance for projections about the future trend of inflation. It has repeatedly been emphasized in previous reports that the relationship between exchange rate developments and inflation has weakened compared to previous periods. It is a fact that exchange rates will continue to be one of the main determinants of inflation in the Turkish economy as it transforms into a more open economy. In a floating exchange rate regime, developments in exchange rate movements become influential on inflation only when they are repeated for a number of successive months and considered to be permanent. For this reason, the effect on inflation of a sudden depreciation in TL following a rapid appreciation is limited, up to a certain threshold. The inflation figures pertaining to the first three months of the year comprises a specific margin with respect to end-year inflation figures. Therefore, the current condition of exchange rates does not pose a significant risk to the end-year inflation target.

6.3. Monetary and Fiscal Discipline

Within the framework of the floating exchange rate regime and the implicit inflation targeting strategy, the CBRT will continue to use overnight interest rates as the main policy instruments in order to attain its primary objective of price stability. In 2006, the CBRT will adopt the inflation targeting strategy. With this implementation, the CBRT will have to make its decisions from a more medium-term perspective.

There is no doubt that public sector dynamics are affected by the high debt stock, which appeared after the 2001 crisis and has gradually been decreasing since that time; the fiscal policy based on indirect taxes, and the uncontrollable structure of certain expense items. This situation, which is defined as fiscal dominance, makes the economy susceptible to internal and/or external shocks. These developments may be influential on economic relations by altering the risk premium in time. The existence and volatility of risk premium increase uncertainties about the direction and the level of relationships in the medium and long term and

limit the efficiency of the implementations carried out in the framework of the monetary policy.

Strict implementation of economic policies has contributed to creating an environment more apt at practicing inflation targeting. The steps taken towards macroeconomic stability in both monetary and fiscal disciplines reduce fiscal dominance. Recently, important achievements in favor of fiscal discipline in the areas of social security reform and tax reform were made regarding the restructuring of revenue administration. Furthermore, more steps should be taken towards expense-reducing and tax-increasing reforms. Meanwhile, YTL-denominated long-term papers issued by international institutions contribute to the extension of the Treasury's borrowing maturity and the reduction of its costs. Provided that these developments continue and structural arrangements are made without delay, uncertainties in the monetary transmission mechanism would diminish.

6.4. Conclusion

To sum up, the developments in employment, productivity and wages, observed as of the last quarter of 2004 support our prediction that labor costs will not contribute to the decline in inflation as much as they did in previous periods. Nevertheless, investment expenditure, which displayed a high rate of increase during 2004, is expected to continue to underpin productivity especially in technology-intensive sectors. At the same time, taking into account unemployment rates and the potential increase in the labor force that will arise from demographical factors in the upcoming years, average labor costs are expected to remain limited under the assumption that wage policy of the public sector would stay in line with inflation targets. Therefore, removing the obstacles to investment and production, and the improvement of institutional governance are crucial for increasing productivity. It should be kept in mind that achieving historic lows in inflation and high growth rates were possible only by ensuring macroeconomic stability and high-rated increases in productivity. A similar process needs to be in place for attaining lasting macroeconomic stability. Hence, the scope of structural reforms of the last three years should be expanded and taken to the next level.

To conclude; except for large external shocks, the CBRT does not foresee any risk for the inflation target in the rest of 2005. In fact, the

latest expectations survey conducted by the CBRT indicates that the end-year inflation expectations decreased to 7.5 percent and thus fell below the target. The supply-demand balance is not expected to pose a significant risk to inflation. Meanwhile, international liquidity conditions, developments in oil prices and the course of unit wages indicate that costs will not further contribute to the decline in inflation in the upcoming period and that monthly inflation figures might be higher in the rest of 2005, compared to the first quarter of the year. Despite the latest cost developments, the inflation target for 2005 is likely to be attained in light of positive expectations and the downward trend observed in the first quarter. However, considering the said developments, the CBRT will continue to remain cautious in the medium term.

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ABBREVIATIONS

AMA	Automotive Manufacturers Association
BRSA	Banking Regulation and Supervision Agency
BTS	Business Tendency Survey
CBRT	Central Bank of the Republic of Turkey
CPI	Consumer Price Index
CSA	Compulsory Saving Account
EU	European Union
FED	Federal Reserve Bank of USA
FX	Foreign Exchange
GDBS	Government Domestic Borrowing Securities
GDP	Gross Domestic Product
GNP	Gross National Product
IMF	International Monetary Fund
ISE	Istanbul Stock Exchange
OPEC	Organization of the Petroleum Exporting Countries
PCT	Private Consumption Tax
PPI	Producer Price Index
SCA	Special CPI Aggregates
SIS	State Institute of Statistics
SMSE	Small and Medium Sized Enterprises
USA	United States of America
VAT	Value Added Tax
WPI	Wholesale Price Index
YTL	New Turkish lira